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Director Liability and the Income Tax Act

The Federal Court of Appeal handed down an interesting and somewhat thought provoking decision on June 27, 1997 regarding directors' personal liability arising from the corporations failure to remit source deductions. The case examined the liability imposed by Section 227.1(3) of the *Income Tax Act* of Canada (the "Act") and the availability of the due diligence defence for directors of corporations which fail to remit the required source deductions.

Moreover, the case provides further judicial analysis of the somewhat more subtle issue of the distinction between "inside directors" and "outside directors", with regard to the due diligence defence.

This article will review the salient issues developed in the case of *Soper vs. The Queen*, 1997 DTC, 5407 and consider the merits of the courts continued distinction between the obligation imposed on inside and outside directors. The article will conclude with a comparative review of Revenue Canada's recently revised Information Circular on directors' liability (N.B. Information Circular 89-2R).

The Due Diligence Defence

The Soper case summarized the obligation imposed on a director with regard to ensuring that the source deductions are made and the availability of the due diligence defence in subsection 227.1(3) of the Act, as follows:

"The standard of care for the due diligence defence is inherently flexible. Rather than treating directors as a homogeneous group of professionals whose conduct is governed by a single, unchanging standard, that provision embraces a subjective element which takes into account the personal knowledge and background of the director, as well as his or her corporate circumstances in the form of, *inter alia*, the company's organization, resources, customs and conduct. Thus, for example, more is expected of individuals with superior qualifications (e.g. experienced business persons)".

The court is clearly making a distinction between those directors who, through their experience, education and history with the corporation, possess a higher degree of skill, than those that don't. Clearly, the court recognizes the need to account for the relative skill of the director.

That is to say, the standard of care, while not purely objective is clearly not purely subjective. The court is not looking simply at whether the failure to remit occurred while the person was acting as a director (i.e. objective) nor is it simply determining whether the director tried his best or acted honestly (i.e. subjective). What the court has determined is that the director must satisfy his duty and in that regard the court identified five legal principles which delineate the directors duty of care.

Firstly, it is clear that directors are not to be equated with trustees, but are more analogous to agents of the company. In this capacity directors stand in a fiduciary relationship to their company.

The court went on to state that a director need not exhibit, in the performance of his or her duties, a greater degree of skill and care than may reasonably be expected from a person of his or her knowledge and experience. The court continued:

"The standard of care is partly objective (the standard of the reasonable person), and partly subjective in that the reasonable person is judged on the basis that he or she has the knowledge and experience of the particular

individual. It is a hybrid “objective subjective standard”.

Thirdly, a director is not obligated to give continuous attention to the affairs of the company, nor is he or she even bound to attend all meetings of the board. Having said that, the court recognized that directors should endeavor to attend board meetings and the director is not relieved of liability on the basis that he or she failed to attend. In commenting on this point, Robertson J.A. drove home this point as follows:

“...it would be silly to pretend that the common law would stand still and permit directors to adhere to a standard of total passivity and irresponsibility... It should be noted here that the law today can scarcely be said to embrace the principle that the less a director does or knows or cares, the less likely it is that he or she will be held liable... Accordingly, the director who acts irresponsibly, for example, by failing to attend all board meetings, now does so at his own peril”.

Fourthly, in the absence of grounds for suspicion, it is not improper for a director to rely on company officials to perform honestly, duties that have been properly delegated to them. The Soper case forcefully and accurately supports the notion that an unskilled director is not under an obligation to obtain competent outside advice and that even an inside director may not be liable if he or she is innocent and has been deceived by co-directors (as opposed to being inattentive and relying on assurances from other directors that “nothing is wrong” with the financial viability of the corporation).

Inside Directors and Outside Directors

As noted immediately above, the courts have historically recognized the distinction between inside directors and outside directors. The former meaning those involved in the day to day management of the company who influence the conduct of its business affairs. Courts have consistently held that it would be more difficult for these inside directors to establish the due diligence defence with regard to the liability opposed in subsection 227.1(3) of the Act. Having said that, not all inside directors have been held liable in previous tax cases. The Federal Tax Court has refused to impose liability on an inside director in cases where he or she is an innocent party who has been misled or deceived by co-directors.

Judicial precedent is fairly well established in its consideration of the liability attaching to outside directors. The outside director may, where he or she has taken positive action by setting up controls to account for remittances, escape liability where the corporation ultimately fails to make the required remittance. Robertson J.A., in the Soper case concluded that:

“While such precautionary measures may be regarded as persuasive evidence of due diligence on the part of a director, in my view, those steps are not necessarily conditions precedent to the establishment of that defense... In my view, the positive duty to act arises where a director obtains information, or becomes aware of facts, which might lead one to conclude that

there is, or could reasonably be, a potential problem with remittance.”

Finally, the court focused on the existence of financial difficulties experienced by the corporation and concluded that Soper was under a positive duty to act when discovering, from the corporations balance sheet, its serious financial problems. Because this should have alerted him to the existence of a possible remittance problem, he was held liable.

Revenue Canada’s Revised Position

In a revised Information Circular issued by Revenue Canada on the day the Soper case was handed down, Revenue Canada altered its position with regard to directors’ liability for unremitted source deductions; however, the Soper decision and the revised Information Circular (N.B. IC 89-2R) are not fully consistent.

Most alarmingly, it is suggested in the Information Circular that there is no distinction between directors, “be they passive, nominee, or outside directors”. While it is accurate to say that the Act does not recognize a distinction between inside and outside directors, the case law certainly does. This was aptly demonstrated in the Soper decision handed down by Robertson, J.A.

The irreconcilable conclusions of the Soper case and Information Circular 89-2R aptly demonstrate the need to be vigilant in going beyond the stated policy of the Canadian tax authority and argues strongly for independent analysis of prevailing Canadian case law.