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DIRECTORS' LIABILITY

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TABLE OF CONTENTS

PAGE

INTRODUCTION 1

FIDUCIARY DUTY AND STANDARD OF CARE 1

DIRECTORS' STATUTORY LIABILITIES 2

A. General 2

B. Directors' Liability under the CBCA 3

C. Defence Mechanisms 3

CAPPING DIRECTORS' LIABILITY 5

DIRECTORS' LIABILITY FOR WAGES 7

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DIRECTORS' LIABILITY

INTRODUCTION

Directors' liability has been an issue of ongoing interest in corporate circles. Much has been written about its impact on the willingness of qualified persons to serve as corporate directors, but the potential economic costs of directors' liability are also of concern. Excessive directors' liability may cause corporate boards to spend significant amounts of time on averting liability, thereby reducing innovation and adversely affecting competitiveness.

Personal liability may be viewed as a burden for directors; however, it can also be an important way to promote compliance and to allocate risk by injecting a measure of accountability into a corporation's dealings with other parties.

The *Canada Business Corporations Act* (CBCA) imposes statutory liabilities on directors of corporations. In addition to these liabilities, directors can be liable to the corporation for breach of their fiduciary duties.

This note will discuss these liabilities and the defences to them that are available in the CBCA.

FIDUCIARY DUTY AND STANDARD OF CARE

The common law, the Quebec Civil Code and corporate statutes impose duties on corporate directors. One of these is a fiduciary duty for directors not to place themselves in a position where their duty to act in the best interests of the corporation conflicts with their personal interests. This principle is codified in section 122(1)(a) of the CBCA, which states that directors of a corporation must "act honestly and in good faith with a view to the best interests of the corporation" when exercising their powers and discharging their duties.

Another of a director's duties is to maintain the standard of care. The statutory standard for the amount of care, diligence and skill required of corporate directors is derived from the common law and has been codified in section 122(1)(b) of the CBCA, which requires directors to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." Directors are thus required to use their training, ability, experience and education in the same way as a reasonably prudent person would do in a similar situation.

DIRECTORS' STATUTORY LIABILITIES

A. General

The CBCA imposes statutory liabilities on directors of CBCA corporations. Under other federal and provincial statutes, directors also face personal liability for environmental offences, wages, source deductions from payrolls, GST remittances, and retail sales tax, among other things.

The theory behind the imposition of directors' personal liability is that the risk of being found liable will make directors more attentive to their legal obligations in managing the corporation. It is felt directors will be prompted to become more active in monitoring corporate compliance with the statutory requirements. Moreover, where a corporation has violated a statutory requirement, the liability of directors provides a means of punishing that violation.

There are basically three ways in which statutes impose liability on directors. In one, liability is imposed whether or not the director intended to commit the offence or even knew that the offence had been committed. In another, liability is imposed on directors unless they are diligent; that is, a "due diligence" defence allows directors to avoid liability where they have taken appropriate steps and instituted procedures. In the third way, liability is imposed on directors who "authorized, permitted or acquiesced in the commission of the offence by the corporation."

B. Directors' Liability under the CBCA

Under the CBCA, directors can be liable:

- for authorizing the issue of shares for a consideration other than money and the consideration received is less than the fair equivalent of the money the corporation should have received (s. 118(1));
- for certain amounts paid by a corporation, for example, financial assistance, share redemptions, dividends, or commissions when the corporation is not solvent (s. 118(2));
- for unpaid debts owed to employees such as accrued wages and vacation pay (s. 119);
- for insider trading[1] (s. 131); and
- under the oppression remedy[2] (s. 241).

C. Defence Mechanisms

The CBCA allows directors to raise a "good faith reliance" defence to many of the liabilities to which they are subject under the Act. Under section 123(4) a director is not liable for improper share issuances or payments (s. 118), unpaid wages (s.119) or breach of fiduciary duty and the duty of care (s. 122) if he or she has relied in good faith on:

i. financial statements represented to him or her by an officer of the corporation or in a written report of the corporation's auditor to reflect fairly the financial position of the corporation; or

ii. a report of a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him or her.

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(1) Insider trading involves corporate insiders such as directors who, in connection with transactions involving securities of the corporation, make use of confidential information for their own benefit or advantage that, if generally known, might reasonably be expected to affect materially the value of the securities.

(2) The oppression remedy allows a complainant to apply to the court for an order in respect of acts or omissions of a corporation or powers of corporate directors that are exercised in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer.

The scope of the CBCA's good faith reliance defence is limited. It allows directors to point to a reliable source of information as justification for their actions, but it does not permit them, in the absence of that specific justification, to show that they acted reasonably in the circumstances.

There have been calls for the enactment of a due diligence defence under the CBCA to replace the present good faith reliance defence. The 1994 report of the Toronto Stock Exchange Committee on Corporate Governance in Canada recommended that legislation imposing liability on directors should ensure that directors are provided with an effective due diligence defence.(3) According to the Report:

> The existence of a due diligence defence will motivate a board to establish a system within a corporation to ensure that the corporate conduct which is the concern of the relevant law does not occur. The existence of the system is no guarantee that the conduct will not occur but the system should substantially reduce the risk.(4)

In November 1995, Industry Canada released a Discussion Paper on the subject of directors' liability under the CBCA which concluded that a due diligence defence would be more fair to directors.

> With a due diligence defence, the directors may act reasonably prudently by relying on financial statements represented to them by an officer of the corporation or by relying on their own assessment of the financial health of the corporation. However, the due diligence defence also recognizes that the nature and extent of the expected precautions will vary under each circumstance. These precautions can include such things as putting in place appropriate controls and systems to monitor and ensure that policies are being implemented, requiring a proper review of periodic reports and taking appropriate action when a problem is brought to the directors' attention.(5)

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(3) The Toronto Stock Exchange, Committee on Corporate Governance in Canada, *Where Were the Directors?* December 1994, p. 36, para. 5.62.

(4) *Ibid*.

(5) Industry Canada, *Canada Business Corporations Act*, Discussion Paper, *Directors' Liability* [hereafter "Discussion Paper"], November 1995, p. 24-25.

The Discussion Paper went on to recommend that section 123(4) of the CBCA be amended to permit directors to avoid liability for wrongful payments by the corporation, unpaid wages, and breaches of duty where the directors had exercised the same degree of care, diligence and skill to prevent the wrongful act that would have been exercised by a reasonably prudent person in comparable circumstances.[6]

The Standing Senate Committee on Banking, Trade and Commerce examined the issues of directors' liability and relevant defences in its August 1996 report *Corporate Governance*.[7] Witnesses before the Committee expressed concern about the expansion of directors' liability and its impact on corporate governance and the conduct of business. They felt that directors should be protected by a due diligence defence except in cases of dishonesty, fraudulent activity, bad faith and self-dealing.

After hearing strong support for adopting a due diligence standard, the Committee recommended that the CBCA should be amended to provide a due diligence defence for corporate directors. This, the Committee noted, would align the CBCA more closely with other federal statutes that impose personal liability on directors and would also provide greater fairness to directors. Moreover, the Committee felt that the presence of such a defence in the CBCA would encourage corporations to put appropriate monitoring systems in place, provide directors who fulfill the due diligence requirements with a measure of comfort as to their personal liabilities, and contribute to better corporate governance in Canada.[8]

More generally, the Banking Committee called for all federal statutes that impose liability on directors to provide directors with a due diligence defence.

CAPPING DIRECTORS' LIABILITY

Whether there should be a cap on the liability of directors was explored in the Industry Canada Discussion Paper and in the Senate Banking Committee report. This issue was debated in the United States in the late 1980s in the wake of a decision of the Supreme Court of

(6) *Ibid*., p. 25.

(7) Senate of Canada, Standing Senate Committee on Banking, Trade and Commerce, *Corporate Governance*, August 1996.

(8) *Ibid*., p. 17-18.

Delaware that found the directors of a particular corporation liable to the shareholders for several million dollars.[9]

After this decision, some States revised their corporations laws to allow corporations to amend their charters to protect directors from liability for breach of certain types of duties. Other States established a cap on the amount of damages that could be awarded against directors in specified circumstances. Still other States introduced laws in which the directors' standard of care was established and limited by statute.

The Industry Canada Discussion Paper outlined several objections to capping directors' liability. These included the transfer of liability and risk to others, such as the corporation, insurers and the injured party and the difficulty of reflecting the differences between large and small corporations.[10]

A number of witnesses appearing during the Senate Banking Committee's hearings on corporate governance discussed the question of capping directors' liability. Some witnesses favoured a cap, others were opposed, and yet others felt that a cap was not warranted under the present liability conditions in Canada but might be advisable if the liability picture for directors were to worsen.

Neither the Senate Banking Committee nor the Discussion Paper supported a cap on directors' liability. The Committee was of the view that a cap could not be effectively implemented through the CBCA. To be truly effective, a cap would have to apply to liabilities imposed under federal and provincial statutes. The Committee felt that it would be difficult to achieve the required level of coordination among the federal and provincial governments to make such a proposal possible.[11]

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(9) *Smith* v. *Van Gorkom,* 488 A2d 858 (Del. 1985). This case arose after the directors of one corporation (Trans Union) approved its merger with another corporation. The draft merger agreement negotiated by the president and chief executive officer of Trans Union was presented to the Trans Union board without prior notice and with no documentation to review. After a discussion of less than two hours, the directors approved the merger. The Supreme Court of Delaware held the directors liable to the shareholders.

(10) Discussion Paper (1995), p. 42.

(11) *Corporate Governance* (1996), p. 24.

DIRECTORS' LIABILITY FOR WAGES

Much of the discussion about directors' liability has focused on directors' liability to employees.

Section 119(1) of the CBCA provides that directors are liable for wages owed to the employees of a corporation. More specifically, it states that directors are jointly and severally liable to corporate employees for all debts not exceeding six months' wages for services to the corporation performed by such employees. A director will not, however, be liable for wages unless:

- the corporation has been sued for the debt within six months after it became due and the debt remains unsatisfied;
- the corporation has commenced liquidation and dissolution proceedings or has been dissolved and a claim for the debt has been proved within six months after the proceedings were commenced; or
- the corporation has instituted bankruptcy proceedings and the claim for wages has been proved within six months after the proceedings began.

In addition, liability for wages will ensue only if the director is sued while he or she holds office or within two years after ceasing to be a director.

Directors are entitled to rely on section 123(4) of the CBCA to exonerate themselves from liability for unpaid wages if they relied in good faith upon:

i. financial statements represented by an officer of the corporation or in a written report of the auditor to reflect fairly the financial position of the corporation; or

ii. a report of a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him or her.

The Discussion Paper made no recommendations about whether to maintain or repeal section 119. It did, however, recommend that if section 119 were to be maintained, it should be amended to confirm and clarify that a director's liability would not extend to statutory or contractual termination or severance pay.[12]

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(12) Discussion Paper (1995), p. 12.

The Standing Senate Committee on Banking, Trade and Commerce examined the question of whether the CBCA should continue to impose liability for wages on directors. Witnesses before the Committee pointed out that directors of companies engaged in labour-intensive industries face significant potential liabilities for employees' wages. Arguing that such liability is outmoded and should be eliminated, some witnesses suggested that unpaid wages were more properly a matter for the *Bankruptcy and Insolvency Act* (BIA).(13)

The Senate Banking Committee agreed that liability for unpaid wages should be dealt with under the *Bankruptcy and Insolvency Act* rather than under the CBCA. The Committee was of the view that the primary purpose of section 119 of the CBCA is to protect employees in the event of the bankruptcy or insolvency of their corporate employer. Because unpaid wages are a debt owed by the corporation to its employees, they should be dealt with under a statute whose purpose is to provide for the orderly payment of debts. An important factor contributing to the Committee's recommendation that liability for unpaid wages should be removed from the CBCA was the Committee's belief that transferring wage liability to the BIA would provide a consistent, nation-wide standard for dealing with this type of liability.(14)

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(13) *Corporate Governance* (1996), p. 28. Under section 136(1)(d) of the *Bankruptcy and Insolvency Act*, workers whose employer is bankrupt have a preferred claim for six months' unpaid wages up to $2,000 and for salespersons' expenses to a maximum of $1,000 covering the same period. Where an insolvent employer makes a proposal to reorganize its business under the Act, unpaid wages and salespersons' expenses up to these maximum amounts must be paid immediately after court approval of the proposal. The claims of directors or officers of a corporation for wages or compensation, however, are not considered preferred claims when a corporation becomes bankrupt (section 140).

(14) *Ibid*., p. 31.