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on record

INSOLVENCY & RESTRUCTURING

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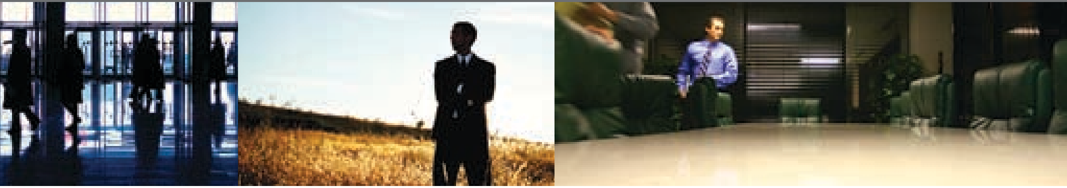

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Director's Liability During Corporate Insolvency

By David A. de Groot

Introduction

Directors of insolvent corporations must make governance decisions in a particularly difficult financial environment.Accordingly, it is important that the directors have a clear understanding of their responsibilities and potential liabilities.As Janis P. Sarra and Ronald B. Davis write:

> Such an understanding will enable those responsible for the corporation's operations and assets to correctly assess their personal liability to the [corporate] stakeholders. It will also enable them to avoid taking steps that could result in increased personal liability resulting from inadvertent breaches of their statutory or common law obligations to the stakeholders during insolvency.[1]

This article commences with an outline of the "corporate veil", which *prima facie* protects directors from being exposed to personal liability, although there are exceptions. The article goes on to outline several key areas of potential personal liability for directors of corporations, including personal negligence, breach of fiduciary duty, the oppression remedy and various statutorily imposed liabilities. The article concludes with a discussion of potential protections available to directors.

Under the *BIA*, a director can also be personally liable for fraudulent preferences. A preference occurs where one creditor is put in a better position than it otherwise would be upon the insolvent corporation's liquidation.

The Corporate Veil

It is a well-established principle that corporations have distinct legal personality, and, as a result, it is the corporation, and not the shareholders or directors, that are liable for the corporation's actions.[2] However, it is recognized that to enforce the corporate veil absolutely would allow directors to make decisions without fear of liability, which could result in inappropriate decisions. Accordingly, courts and legislatures have recognized that directors should be personally liable for their actions in certain circumstances. In the sections that follow, the more prevalent forms of personal liability for directors are discussed.

Classes of General Liability

Common Law Liability for Negligent Acts

The law with respect to the personal liability of directors for activities engaged in for the corporation's benefit, but which cause damage to third parties, is somewhat uncertain. *In ScotiaMcLeod Inc. v. Peoples Jewellers Ltd.,*[3] the Court held that absent fraud, deceit, dishonesty or want of authority, directors would rarely be liable for their conduct unless they acted outside the scope of their duties. However, in *Systems International Ltd. v. Valcom Ltd.,*[4] the same Court held that directors are liable for conduct causing damage even if the conduct was directed to the best interest of the corporation. Given this uncertainty, directors should be cautious when engaging in activities that could result in claims of personal negligence, even if the director is engaging in the activity for the purpose of benefiting the corporation. That said, where the conduct of the director could result in a claim of personal negligence, but would also result in a claim of breach of contract against the corporation (e.g. wrongful interference with contractual relations against a director and breach of contract against a corporation) no liability will likely be imposed on the director.[5]

Breach of Fiduciary Duty to the Corporation

All directors have a fiduciary duty to their corporation. The director's fiduciary duty requires that he or she act honestly and in good faith with a view to the best interests of the corporation.[6] Previously, some commentators suggested that a director's fiduciary obligation shifted to the corporation's creditors as the corporation approached the "vicinity of insolvency". This argument was premised on the understanding that the residual beneficiaries were no longer the shareholders but the creditors. However, in *People's Department Stores Inc. (Trustees of) v. Wise*[7] *("Wise"),* the Supreme Court of Canada rejected this approach and held that at all times directors owe a fiduciary duty to the corporation, which includes all stakeholders. Accordingly, while directors do not owe a direct fiduciary duty to creditors, directors must still consider the interests of creditors as one group of corporate stakeholders; a failure to do so, which harms the corporation, could result in a breach of the director's fiduciary duty to the corporation and hence personal liability.

Oppression Remedy

Part of the Supreme Court of Canada's reasoning in *Wise* for not imposing a creditor-specific fiduciary duty in the "vicinity of bankruptcy" was the existence of the oppression remedy. The oppression remedy allows a court to make an order to rectify a complaint where the powers of the directors of the corporation are or have been exercised in a manner that is oppressive or unfairly prejudicial.[8] Of importance is the fact that creditors can be complainants. The Supreme Court of Canada has recently considered the corporate oppression remedy and held that two conditions must be met before a court will hold that the director's actions are oppressive: (a) the complainant's reasonable expectations must have been breached, and (b) the breach is "oppressive" or "unfairly prejudicial", or the breach "unfairly disregards" the complainant's interest.[9]

Specific Statutory and Regulatory Offences

In many cases, legislators have enacted statutes that impose personal liability on directors. These personal liabilities have been adopted because of fairness and governance problems with the corporate veil. In particular, these offences attempt to prevent directors from making detrimental governance decisions. As well, they attempt to promote fairness by protecting legitimate creditor interests. As Sarra and Davis write:

> The provisions recognize that directors are in the best position to ensure the corporation meets its obligations, to ensure against failure to do so, and to allocate risk in a cost-effective way. By potentially being liable..., directors have incentive to prevent harms and liability where possible. They are also in a position to ensure that the corporation directs its resources, as much as possible, to remedying or preventing such harms.[10]

While most of these offences are strict liability offences (i.e. no intent is necessary), most have "due diligence" defences. "Due Diligence" means that the director has taken all reasonable steps to avoid the harms for which the director is potentially liable.

Improper Dividends

Under the Alberta *Business Corporations Act (the "ABCA"),* if a director declares a dividend while the corporation is insolvent, or the dividend renders the corporation insolvent, the director is personally liable for the amount of the dividend.[11] This provision mirrors various provisions in the Bankruptcy and Insolvency Act (the *"BIA"*).[12]

Bankruptcy Offences

The *BIA* codifies a number of offences for which directors are personally liable. These offences relate to directors' conduct during various periods prior to the "date of the initial bankruptcy event", and have been enacted on the rationale that directors are aware of the corporation's financial difficulties but creditors are not. For instance, under sections 198 and 200 of the *BIA,* a director may be found personally liable for a number of offences including (among others):

- making any fraudulent disposition of the bankrupt's property;
- obtaining credit or property by false representations made by the bankrupt or made by any other person to the bankrupt's knowledge;
- fraudulently concealing or removing any property of a value of fifty dollars or more or any debt due to or from the bankrupt;

- hypothecating, pawning, pledging or disposing of any property that the bankrupt has obtained on credit and has not paid for, unless in the case of a trader the hypothecation, pawning, pledging or disposing is in the ordinary way of trade and unless the bankrupt had no intent to defraud; and
- failing to keep and preserve proper books of account.[13]

Each of these offences is punishable by up to a $5,000 fine or one year imprisonment. Furthermore, the court has the discretion when imposing a sentence, to order the director to pay to the person who has suffered loss or damage an amount to compensate the individual for the loss or damage.[14] The BIA includes a number of other regulatory offences with which directors must be familiar. In most cases there are due diligence defences available.

Reviewable Transactions, Fraudulent Preferences and Fraudulent Conveyances

Under the *BIA's* reviewable transaction provisions, directors can be held personally liable for the difference in the market price and the purchase/sale price of an item if that sale occurred between non-arm's length parties within the past year and if the difference between the market price and actual price is "conspicuously" greater or lesser than the market price. Whether parties are non-arm's length or not is a question of fact; however, the *BIA* deems "related parties" (e.g. blood relatives or corporate subsidiaries) to be non-arm's length parties.[15]

Under the *BIA*, a director can also be personally liable for fraudulent preferences. A preference occurs where one creditor is put in a better position than it otherwise would be upon the insolvent corporation's liquidation. Under section 95 of the *BIA*, a preference requires evidence (i) of a conveyance, transfer or payment within three months prior to the date of the initial bankruptcy event, (ii) that the debtor was insolvent at the time of the conveyance, transfer or payment, and (iii) that the conveyance, transfer or payment gave a preference to a creditor.[16] A fraudulent preference requires evidence that the conveyance, transfer or payment was entered into with the intention to create a preference.[17] Directors have various defences available to rebut the presumption that a preference was given. For instance in *Re Norris,*[18] the Court outlined the ordinary course of business and diligent creditor defences.

In addition to these liabilities under the *BIA*, provincial preference and fraudulent conveyance legislation is also enforceable and has the potential to create personal liability for directors. In Alberta, the relevant act is the *Fraudulent Preferences Act.*[19]

Federal Tax Liabilities

Under the *Income Tax Act,*[20] the *Canada Pension Plan,*[21] the E*mployment Insurance Act,*[23] and the *Excise Tax Act,*[23] directors are personally liable for any amounts that the corporation fails to remit to the government for (i) income taxes, Canada pension plan and employment insurance deductions that the corporation fails to deduct from employees' wages; and (ii) goods and services taxes. Due diligence defences are available for each of these deductions. As well, since the *BIA* and the *Companies' Creditors Arrangement Act (the "CCAA")*[24] both preserve the validity of deemed trusts for these payments, directors' liabilities may be limited as the amounts can be taken from the estate of the bankrupt corporation.

Employment Wages

During an insolvency, employees are in a particularly vulnerable position as they are "involuntary creditors"; and while the *BIA* grants employees a partial preference for their wage claims,[25] such preferences are often insufficient when all forms of employee compensation (including wages, benefits,

Most directors will be entitled to be indemnified by the corporation for their negligent acts which were carried out in good faith; however, where the corporation has not purchased insurance to provide the indemnity or has not granted security to the directors, the right of indemnification is a hollow remedy.

vacation pay and other entitlements) are considered. Given this problem, provincial legislatures, including Alberta, have enacted legislation making directors personally liable for unpaid wages.

In particular, the *ABCA*, at section 119(1) states, "[d]irectors of a corporation are jointly and severally liable to employees of the corporation for all debts not exceeding 6 months wages payable to each employee for services performed for the corporation while they are directors." This use of the term "wages" would include vacation pay but not severance or termination pay.[26] The *ABCA* goes on to create various defences. For example, if the director believes on reasonable grounds that the corporation can pay the debts, the director is not liable.[27] Another example is that a director is only liable if the employee sued the corporation for the debt within six months of the debt becoming due and the execution of the judgment has been returned unsatisfied.[28]

As well, section 112(2) of *Alberta's Employment Standards Code (the "Code")* states, "the directors of a corporation are jointly and severally liable to an employee of the corporation for unpaid wages earned during a period not exceeding 6 months."[29] The *Code* defines wages as "salary, pay, money paid for time off instead of overtime pay, commission or remuneration for work" but does not include overtime pay, vacation pay, general holiday pay, termination pay, bonuses or gifts, expenses or allowances, and tips or gratuities.[30] The *Code* establishes defences for those who were not directors at the time the wages were earned or if the director would not be liable under certain of the defences that are available under the *ABCA*.[31] Importantly, not all the defences available under the *ABCA* are incorporated into the *Code*.

Overall, these provisions have been enacted in order to create "an incentive for directors to ensure that these obligations to employees are met, even where the corporation begins to be financially distressed."[32]

Private Pension Contributions

Similar to employee wages, directors can be held personally liable if the corporation fails to remit private pension contributions for current service costs because, in general, private pension contributions are part of an employee's contractual wage obligation. This liability applies to both defined benefit and defined contribution pension plans. In the case of defined benefit plans, however, directors may face additional contribution liability if there is a solvency deficiency or unfunded liability that results in the need for special payment contributions.

Additional personal liability for directors is created if the wages have been deducted, held in a common law trust (not a deemed trust),[33] but then used for a purpose other than for pension benefits. In these cases, directors face potential exposure for breaches of trust, knowing receipt of trust funds or knowing assistance of a breach of trust. However, holding contributions in a common law trust can protect the trustees since these funds are then earmarked for the employees and their claims are therefore met.[34]

Another area where directors may face personal liability is if they act as administrators of the pension fund and there is evidence that the director failed to act in the best interest of the plan members. In particular, section 13(5) of the *Employment Pension Plans Act (the "EPPA")* states that administrators stand in a fiduciary capacity with regards to plan members.

Environmental Claims

Another area where directors are increasingly becoming exposed to personal liability is in the field of environmental regulation. In Alberta, the *Environmental Protection and Enhancement Act (the "EPEA")* states:

> Where a corporation commits an offence under this Act, any officer, director or agent of the corporation who directed, authorized, assented to, acquiesced in or participated in the commission of the offence is guilty of the offence and is liable to the punishment provided for the offence, whether or not the corporation has been prosecuted for or convicted of the offence.

For example, in *Legal Oil and Gas Ltd. v. Alberta (Minister of Environment)*,[36] the Alberta Court of Queen's Bench upheld a decision of the Environmental Appeal Board holding that a director of a company was liable for the cost of cleaning up contaminants. In addition to liability for damages, the EPEA can be used to force a person who has accrued a monetary benefit while breaching the Act to disgorge that benefit.

While the *EPEA* creates a number of areas for potential personal liability, section 229 establishes a due diligence defence for a number of those offences.In *R. v. Shell Canada Ltd.*, the Alberta Provincial Court held:

> I agree entirely with the position put forward that the standard of reasonable care in assessing the defence of due diligence must involve a proportionality test. It must be looked at in context. What is the activity being regulated? What are the risks involved? What is the potential harm? What is the potential benefit? These are some of the questions that should be addressed in determining what level of care is reasonable.[38]

Protections Against Liability

Most directors will be entitled to be indemnified by the corporation for their negligent acts which were carried out in good faith; however, where the corporation has not purchased insurance to provide the indemnity or has not granted security to the directors, the right of indemnification is a hollow remedy. Accordingly, directors must be aware of other potential avenues to redress their potential personal liability.

An obvious remedy to avoid having to pay personally is for directors to obtain their own insurance to provide protection in the event that personal liability is established.

Another option is that both the *BIA* and the *CCAA* contain provisions that allow insolvent corporations to compromise claims against directors,[39] though both acts prevent directors from being able to compromise claims for negligent misrepresentations, oppressive conduct or activities not associated with their position as directors.[40] As such, provided the claim can be compromised, directors can attempt to include their personal liabilities in a proposal or plan of arrangement.

In CCAA cases in Alberta, the court can grant in the initial CCAA order, a priority charge on the Debtor's assets to secure the corporate indemnity to the directors. In addition, a directors' trust may be established upon insolvency whereby cash is deposited into trust as security for the corporate indemnity.

Conclusion

Overall, while directors theoretically have some protection from liability by virtue of the corporate veil, in reality there are a large number of exceptions to the general rule. Moreover, in the vicinity of bankruptcy the director's right of indemnification becomes an increasingly hollow remedy. Accordingly, directors must be cognizant of their potential personal liability and should take steps to limit their exposure and to become aware of the responses available in the event that personal liability is established.

Footnotes

[1] Janis P. Sarra and Ronald B. Davis, *Director and Officer Liability in Corporate Insolvency* (Markham, Ontario: Buttersworth, 2002) at 1.

[2] *Salomon v. Salomon & Co.,* [1897] A.C. 22 (H.L.)

[3] (1995), 26 O.R. (3d) 481 (C.A.).

[4] (1999), 43 O.R. (3d) 101 (C.A.).

[5] *Said v. Butt,* [1920] 3 K.B. 497.

[6] *Business Corporations Act, R.S.A.* 2000, c. B-9, s. 122(1)(a).

[7] [2004] 3. S.C.R. 461.

[8] *Business Corporations Act,* R.S.A. 2000, c. B-9, s. 242(2)(c).

[9] *BCE Inc. v. 1976 Debenture Holders,* 2008 SCC 69 at para.68.

[10] *Supra* note 1 at 51.

[11] *Supra* note 8 at section 43 and 118(3).

[12] R.S.C. 1985, c. B-3.

[13] *BIA,* sections 198 and 200.

[14] *BIA,* section 204.3(1).

[15] *BIA,* sections 3, 4 and 100.

[16] *BIA,* sections 95 and 96.

[17] *Re Green Gables Manor Inc.,* (1998), 4 C.B.R. (4th) 273 (Ont. Gen. Div.).

[18] (1994), 28 C.B.R. (3d) 167 (Alta. Q.B.).

[19] R.S.A. 2000, c. F-24.

[20] R.S.C. 1985 (5th Supp.), c. 1 as amended, s. 227.1

[21] R.S.C. 1985, c. C-8 as amended, s. 21.1.

[22] S.C. 1996, c. 23 as amended, s.107.

[23] R.S.C. 1985, c.E-15 as amended, s. 323(1).

[24] R.S.C. 1985, c. C-36.

[25] *BIA,* section 136(1)(d).

[26] *Supra* note 1 at 100.

[27] *Business Corporation Act,* section 114(2)(a).

[28] *Business Corporation Act,* section 114(3)(a).

[29] *Employment Standards Code,* R.S.A. 2000, c. E-9 as amended, s. 112(2).

[30] *Code,* section 1(1)(x).

[31] *Code,* section 112(3)(a) and (b).

[32] *Supra* note 1 at 89.

[33] Section 51 of the *Employment Pension Plans Act,* R.S.A. 2000, c. E-8 deems all pension contributions to be held in trust; however, by virtue of the *BIA,* these trust provisions are not enforceable in bankruptcy.

[34] See *Edmonton Pipe Industry Pension Plan Trust Fund (Trustees of) v. 350914 Alberta Ltd.* (2000), 80 Alta. L.R. (3d) 225 (C.A.).

[35] *Environmental Protection and Enhancement Act,* R.S.A. 2000, c. E-12 as amended, section 232.

[36] (2000), 84 Alta. L.R. (3d) 159 (Q.B.).

[37] *EPEA,* section 230.

[38] (1999), 253 A.R. 143 (Prov. Ct.).

[39] *BIA* section 50(13); CCAA section 5.1(1).

[40] *BIA* section 50(14); CCAA section 5.1(2).

Put the Boots to Hunger

BD&P is excited about the recent launch of its joint Stampede-themed fund and food raising campaign with the Calgary Inter-Faith Food Bank — that of "PUT THE BOOTS TO HUNGER". In light of Calgary's not-for-profit sector finding the current economic times extremely challenging — both financially and through sustainable volunteer support — BD&P decided commit $150,000 to launch and promote the initiative during Stampede week, 2009.

The overall goal of the PUT THE BOOTS TO HUNGER campaign in 2009 is to raise at least $500,000.

BD&P hopes that the PUT THE BOOTS TO HUNGER campaign will provide the opportunity to witness the true "Stampede Spirit" of community support. The proposed elements of the PUT THE BOOTS TO HUNGER initiative offers the Calgary Food Bank a unique and valuable opportunity to raise awareness in our community and to inspire individuals, community groups and corporations to support BD&P in achieving this goal — "to provide quality, emergency food to those in need".

If the demand for the Calgary Food Bank's services continues as it did during the fall of 2008 and in early 2009, the Food Bank will experience its largest need for emergency food hampers in nearly 10 years. The majority of people relying on the Food Bank for emergency food hampers continue to be the working poor. It is our goal to provide the Calgary Food Bank with the resources it needs to ensure that all Calgarians who need to rely on the Calgary Food Bank can do so.

For more information on how to participate in the Campaign, please visit **www.puttheboots tohunger.com**

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