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Résumé de l'article

Depuis le début des années 80, les tribunaux ont tenu certains administrateurs personnellement responsables du défaut de leur compagnie d'effectuer certains paiements au fisc, notamment en vertu de l'article 227.1 de la Loi de l'impôt sur le revenu. L'auteur examine les devoirs traditionnels de soin, de prudence et de diligence des administrateurs dans le cadre de cette loi.

Directors' Diligence Under the Income Tax Act[1]

by

R. Lynn Campbell[2]

Depuis le début des années 80, les tribunaux ont tenu certains administrateurs personnellement responsables du défaut de leur compagnie d'effectuer certains paiements au fisc, notamment en vertu de l'article 227.1 de la Loi de l'impôt sur le revenu. *L'auteur examine les devoirs traditionnels de soin, de prudence et de diligence des administrateurs dans le cadre de cette loi.*

Normally, fiduciary duties are employed to control the conduct of directors and thus preserve the capital of a corporation. In the exercise of corporate powers a director stands in a fiduciary relationship with the corporation and must exercise corporate powers in good faith and with loyalty. A director must act in the best interests of the corporation, exercise the powers for the purposes for which they were conferred and must not place himself/herself in a position of conflict between self-interest and duty to the corporation. These principles permit the law to monitor the conduct of directors and make them civilly liable for breaches of fiduciary duty. Another consequence is that a standard of acceptable conduct of directors has been drawn with the ultimate goal of benefitting the economic success of the corporation.[3]

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[1]Reprinted from *Canadian Business Law JOURNAL*, Volume 16, Number 4, July 1990, with permission of the author.

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[3]Laskin J., in *Canadian Aero Service Ltd.* v. *O'Malley*, [1974] 1 S.C.R. 592 at p. 610, 40 D.L.R. (3d) 371, noted that the reason for imposing high standards of conduct on directors was because of their control over corporate operations. He stated:

"What these decisions indicate is an updating of the equitable principle whose roots lie in the general standards that I have already mentioned, namely, loyalty, good faith and avoidance of a conflict of duty and self-interest. Strict application against directors and senior management officials is simply recognition of the degree of control which their positions give

Until recently, it was only the good faith and loyalty component of the fiduciary duty that was employed to determine the acceptable level of conduct. The other component of the duty — care, diligence and skill — had not been utilized to define an acceptable level of conduct because the common law applied a subjective standard.[4] In practice, this meant that a director had to attain only his/her own level of competence and thus was given an effective defence to any allegation of breach of duty of care, skill and diligence. The attempt to upgrade the level of this duty by statute had not been used as a tool to define acceptable limits of

director conduct.[5]

In the early 1980s the Income Tax Act did use the care, diligence and skill duty to define an acceptable limit of conduct of directors.[6]

However, the Income Tax Act did not employ this aspect of the fiduciary duty as a means of ensuring that corporate capital was protected. The Act employed this duty as a standard of determining whether a director was civilly liable for payments which the corporation had failed to make to Revenue Canada. Needless to say, this has generated considerable litigation and has caused a great deal of consternation among directors.

Background

Corporations, as employers, are required to deduct income taxes from employees' wages and to remit the deductions to Revenue Canada on the fifteenth day of the following month.[7] Failure to do so may result in director civil liability. Section 227.1(1) provides:

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them in corporate operations, a control which rises above day-to-day accountability to owning shareholders and which comes under some scrutiny only at annual general or at special meetings."

[4]See *Re City Equitable Fire Insurance Co. Ltd.*, [1925] 1 Ch. 407 (C.A.).

[5]For example, see Canada Business Corporations Act ("CBCA"), R.S.C., 1985, c. C-44, s. 122, and Ontario Business Corporations Act, 1982 ("OBCA"), S.O. 1982, c. 4, s. 134. See also, B. Welling, *Corporate Law in Canada: The Governing Principles* (Toronto, Butterworths, 1984), pp. 331-5.

[6]Income Tax Act, S.C. 1980-81-82-83, c. 140, s. 124(1), adding s. 227.1(3) to the Income Tax Act.

[7]Income Tax Act, S.C. 1970-71-72, c. 63, s. 153.

> (1) Where a corporation has failed to deduct or withhold an amount as required by subsection 135(3) or section 153 or 215, has failed to remit such an amount or has failed to pay an amount of tax for a taxation year as required under Part VII or VIII, the directors of the corporation at the time the corporation was required to deduct, withhold, remit, or pay the amount are jointly and severally liable, together with the corporation, to pay that amount and any interest or penalties relating thereto.

The main reason for the enactment of s. 227.1(1) in late 1981 was to remedy the previous ineffective system of tax collection. Earlier statutory provisions providing for the civil or criminal liability of corporations did not always enable tax officials to collect amounts due from delinquent corporate taxpayers.[8] Income taxes were often unsecured debts of the federal Crown, thus Revenue Canada was prevented from using collection techniques on assets already subject to claims of secured creditors.[9] Also, statutory trusts established in favour of Revenue Canada were not very effective because they were often subject to provincial claims or claims by other statutory agencies.[10] In addition, any commingling of trust moneys and corporate funds made the establishment of a trust in favour of Revenue Canada difficult to prove.[11]

Section 227.1(1) extends civil liability to directors for default of payment by a corporation. If the losses are to be fairly allocated or distributed among other taxpayers, then the directors may be the appropriate persons to bear the loss occasioned by the corporation which they control. The directors may have been in a position to prevent the loss or may have caused the loss through corporate mismanagement. Other taxpayers should not have to bear the cost of unpaid corporate remittances because they will not have shared in

[8]See E.G. Kroft, "The Liability of Directors for Unpaid Taxes," in *Report of Proceedings of the Thirty-Seventh Tax Conference*, 1985 Conference Report (Toronto, Canadian Tax Foundation, 1986), p. 30:4.

[9]*Information Circular* 75-16R, "Collection Policy," January 16, 1982.

[10]*The Royal Bank of Canada* v. *The Queen* (1984), 84 D.T.C. 6439 (F.C.T.D.); *Deloitte Haskins & Sells Ltd.* v. *Workers' Compensation Board*, [1985] 1 S.C.R. 785, 55 C.B.R. (N.S.) 241.

[11]*Dauphin Plains Credit Union Ltd.* v. *Xyloid Industries Ltd.*, [1980], 1 S.C.R. 1182, 108 D.L.R. (3d) 257; *Coopers & Lybrand* v. *Canada* (1981), 39 C.B.R. (N.S.) 247 (B.C.S.C. in Chambers); *Re Phoenix Paper Products Ltd.* (1983), 48 C.B.R. (N.S.) 113 (Ont. C.A.), now overruled by *B.C.* v. *Henfrey Samson Belair Ltd.*, [1989] 2 S.C.R. 24, 59 D.L.R. (4th) 726.

any of the benefits derived from the activities creating the tax liability.[12]

Directors should not be liable, however, for the default of the corporation unless they have specific obligations to the Crown. Under the Income Tax Act, any amount deducted or withheld from employees' wages is deemed to be held in trust for Her Majesty.[13] Thus, the corporation and the directors who manage it are in a fiduciary position to the Crown. Directors, as managers of the corporation, act as trustees of these funds and are vicariously responsible for their payment.[14] In contrast, the corporation does not always act as trustee for all taxes it is required to pay. For example, taxes payable by a corporation on its own capital and income are not deemed to be held in trust. Consequently, the directors are not responsible for the shortfall of the corporation with respect to these taxes, absent any criminal conduct on their part.[15]

The vicarious liability of directors for the corporation's failure to remit employee deductions, however, is not strict. Liability may be avoided by showing that the director took reasonable care and did what a reasonable person would have done in comparable circumstances. Section 227.1(3) provides:

> (3) A director is not liable for a failure under subsection (1) where he exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.

This provision excuses a director from liability if he/she has met certain standards in performing their directorial obligations.[16] Section 227.1(3) adopts the same formulation of care, diligence and skill as is found in the CBCA.[17] The conduct of directors required to

[12] Kroft, *supra*, footnote 6, at p. 30:7.

[13] *Supra*, footnote 5, s. 227(4).

[14] *Supra*, footnote 4, s. 227.1(1).

[15] Kroft, *supra*, footnote 6, at p. 30:9.

[16] *Lloyd Youngman & Co. Inc.* v. *M.N.R.* (1987), 87 D.T.C. 250 at p. 251, 37 B.L.R. 309 (T.C.C.).

[17] For discussion of the CBCA provision, see F. Iacobucci, M. Pilkington and J.R.S. Prichard, *Canadian Business Corporations* (Toronto, Canada Law Book, 1977), pp. 289-93; and Welling, *supra*, footnote 3, at pp. 331-5.

successfully invoke this defence is, however, quite different from the standard to which directors have traditionally been accustomed.

New Attention Is Required

The traditional starting point for determining the standard of care, diligence and skill required of a director has been *Re City Equitable Fire Insurance Co. Ltd.*[18] This case established a subjective standard of care and skill which was not very demanding. A director did not have to exhibit a greater degree of skill than would be expected from a person of his knowledge and experience. As a director was not liable for errors in judgment, he *could utilize* his own talents with respect to corporate risk-taking. Also, a director was not bound to give continuous attention to the affairs of the corporation and was entitled to rely upon subordinates in the absence of grounds for suspicion.[19]

In most jurisdictions in Canada, legislation has attempted to revise the directorial standard of care, skill and diligence.[20] A director must now exercise the standard of a reasonably prudent person in comparable circumstances. The standard of care, diligence and skill required will vary according to the facts of each case. The precise level required will depend upon the court's notion of "reasonableness," "prudence" and "comparable circumstances." Clearly, there is ample flexibility in these words to allow a court to determine each case on its own facts.

Although s. 227.1(3) of the Income Tax Act is patterned after the CBCA, the words "to prevent the failure" have been added. This addition makes a difference for two reasons. First, the "failure" referred to is the statutory obligation of the corporation under the Income Tax Act to deduct and remit taxes. As such, there is no discretion to be exercised nor business judgment required by a

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[18] *Supra*, footnote 2.

[19] *Re Denham & Co.* (1883), 25 Ch. D. 752. See, also *Re Brazilian Rubber Plantations and Estates Ltd.*, [1911] 1 Ch. 425 at p. 438; and *Prudential Trust Co.* v. *McQuaid* (1919), 45 D.L.R. 346, [1919] 1 W.W.R. 523 (Alta. C.A.). For criticism of this low standard, see Welling, *supra*, footnote 3, at p. 328.

[20] *Supra*, footnote 3. For commentary, see Iacobucci, Pilkington and Prichard, *supra*, footnote 15 at p. 290.

director.[21] The obligation must be complied with, otherwise a director will be vicariously liable for the breach of s. 227.1(1). Second, in order to act to "prevent the failure," a director must take positive action.[22] Thus, a director's attention to the affairs of the corporation and reliance on subordinates are brought into question. If no steps are taken to prevent the "failure," then s. 227.1(3) will be of no assistance to a director.

What this means is that, in determining the level of conduct required to comply with s. 227.1(3), the care and skill components of the standard will be given minimal attention. Diligence, on the

other hand, will be of prime importance. The level of diligence will be determined by the court's application of the variables of "reasonably prudent person" and "in comparable circumstances." Therefore, the facts of each case will still set the limits of liability. Any change in the standard of conduct required will depend upon the court's notion of diligence and prudence relative to the obligations imposed under the Income Tax Act.

Diligence means more than attentive care or vigilance. It includes the steady application of these qualities to particular circumstances.[23] The degree of diligence to be exercised is that of the reasonably prudent person. This degree is to be contrasted with a high degree or slight degree of diligence. A director does not have to exercise a diligence that very prudent persons take in their own affairs or that of persons who have a special expertise. In contrast, a director must exercise a greater degree of diligence than persons with less than common prudence or no prudence at all. The diligence required is a fair and proper degree of care that a reasonably prudent person would exercise in his own affairs.

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[21] This distinction was noted by Rip T.C.J. in *Merson* v. *M.N.R.* (1988) 89 D.C.T. 22 at p. 28, [1989] 1 C.T.C. 2074. He stated, "A director who manages a business is expected to take risks to increase the profitability of the business and the duties of care, diligence and skill are measured by this expectation. The degree of prudence required by subsection 227.1(3) leaves no room for risk."

[22] *James* v. *Barnett* (1985), 85 D.T.C. 619, and, *infra*, text at footnote 30. See also, Revenue Canada Directive CA 87-67, October 6, 1987. Contrast with *Cybulski* v. *M.N.R.* (1988), 88 D.T.C. 1531, *per* Christie T.C.J.

[23] *Moore* v. *M.N.R.* (1988), 88 D.T.C. 1537 at p. 1541.

Prudence, on the other hand, means the exercise of sound judgment.[24] The level of judgment to be exercised is that of a reasonably prudent person. This judgment must be contrasted with business judgment which involves commercial risk and business discretion. It is the exercise of these judgments which will either increase or decrease corporate capital. The judgment required of prudence, however, is a judgment in practical affairs in which the element of discretion or expertise is minimized.[25] This is the type of judgment that one would expect from a reasonably prudent person.

The common link between the diligence and prudence required of a director in s. 227.1(3) is the statutory duty to ensure that the corporation deducts, withholds and remits employee income tax deductions. Specifically, as provided in s. 227.1(3), it is the diligence and prudence required to prevent the corporation from failing to comply with s. 153 of the Income Tax Act. Whether the required diligence and prudence has been met will be determined by the facts of each case in light of these statutory duties.

Diligence and prudence are not the only considerations to be taken into account in order to determine whether a director can invoke the protection of s. 227.1(3). Because liability arises from involvement in a corporate structure, authority and knowledge must be considered as well. Authority is a consideration because corporate authority is often delegated to individual directors.[26] This is specifically relevant to s. 227.1(3) because a director must take positive steps to prevent the corporate breach under s. 153. Knowledge must also be considered because it is essential in determining the level of attention that a reasonably prudent person would have taken.

Diligence

Attentive care and vigilance to a plethora of statutory obligations can be burdensome to a busy corporate director.

[24] *Moore* v. *M.N.R.* (1988), 88 D.T.C. 1537 at p. 1541.

[25] *Ibid.*

[26] Authority to manage and supervise the affairs of a corporation is invariably vested in the board of directors. This authority, however, is subject to any unanimous shareholder agreement. See CBCA, s. 102(1) and OBCA, s. 115(1).

However, the Tax Court of Canada has shown little sympathy to such an argument.

In *James* v. *Barnett*[27], Mr. Barnett, a marketing specialist, bought out his partner who had looked after administrative and financial matters. Upon the advice of the company's accountant, a comptroller was hired who had complete authority and responsibility over financial matters. A customer defaulted on a large payment and as a result, the company suffered a severe cash shortage. Mr. Barnett instructed the comptroller to pay only essential suppliers which did not include Revenue Canada. Mr. Barnett was assessed under s. 227.1(1).

He argued that he could delegate financial matters to a competent person and had no duty to constantly monitor his actions. The Tax Court rejected these arguments and held that delegation in the circumstances did not assist the appellant because he had paid no attention to the performance of the company's statutory duties.[28] Although the appellant did not appreciate this, the duties included keeping employee deductions in a separate trust account. In addition, the taxpayer gave the comptroller instructions when the corporate financial position was rapidly worsening.[29]

A director may not be excused of liability under s. 227.1(1) even if he/she was unaware of the corporation's statutory obligations under the Income Tax Act. This position is true even if the corporation has delegated *de facto* responsibility for financial administration to another director who has knowledge in this area.

This was the case in *Lloyd Youngman & Co. Inc.* v. *M.N.R.*[30] Mr. Fraser was a director in charge of manufacturing, production and shipping. He held 15% of the shares. The other two directors who held 48% and 37% of the shares were the president and treasurer who was a chartered accountant. They were responsible for the financial administration. When Mr. Fraser became aware of a problem with Revenue Canada, he made inquiries as to its nature.

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[27] *Supra*, footnote 20.

[28] Mere delegation of statutory duties to a competent person is not sufficient to meet the s. 227.1(3) defence.

[29] See, R.L. Campbell, "The Fiduciary Duties of Corporate Directors: Exploring New Avenues" (July/August 1988), 36 Can Tax J. 912.

[30] (1987), 87 D.T.C. 250, *per* Bonner T.C.J.

His co-directors assured him that an account receivable would be applied to the arrears owing to Revenue Canada. Two months later when the business was closing, Mr. Fraser was again assured by the president and treasurer that a receivable would be used to pay the arrears. At no time did he attempt to learn the exact nature of the indebtedness. Mr. Fraser was assessed under s. 227.1(1) because the company failed to remit employee deductions.

Mr. Fraser argued that he was entitled to rely on the assurances of the other two directors because he lacked knowledge of the circumstances. He had no knowledge of the financial affairs of the company nor was he authorized to give instructions regarding the payment of creditors. Further, he had no reason not to trust his co-directors. His inquiries and the subsequent assurances were sufficient to bring himself within s. 227.1(3).[31]

The Tax Court rejected these arguments. It held that after the problem with the arrears came to his attention, the appellant did nothing to prevent further defaults. Ignorance of the requirements of the Income Tax Act did not excuse the taxpayer. Also, complacent acceptance of assurances that prior defaults would be rectified was not sufficient to comply with corporate statutory obligations, which included keeping deductions separate from other funds.[32] Further, the taxpayer had not made any attempt, as a director, to ensure that the corporation formulated policies to comply with its statutory obligations. In addition, the presence on the board of a capable person who could have prevented the default was not sufficient, by itself, to afford any protection under s. 227 1(3).[33]

The fact that a corporation has delegated the responsibility of financial affairs to one or more members of the board of directors

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[31] (1987), 87 D.T.C. 250, *per* Bonner T.C.J., at p. 251.

[32] Section 227(5) of the Income Tax Act stated: "All amounts deducted or withheld by a person under this Act shall be kept separate and apart from his own moneys and in the event of any liquidation, assignment or bankruptcy the said amounts shall remain apart and form no part of the estate in liquidation, assignment or bankruptcy." Section 227(5) has since been repealed and substituted. See, S.C. 1986, c. 6, s. 118(1), and S.C. 1988, c. 55, s. 171(1).

[33] The court felt that Mr. Fraser was a sufficiently "intelligent man" to comply with s. 227(5). At least, he had the ability to cause the company to formulate policies to ensure compliance with s. 227(5). For possible impact of the repeal of s. 227(5), see Campbell, *supra*, footnote 27.

does not excuse a director from ensuring that corporate statutory duties have been complied with. This is particularly true if the corporation is encountering financial difficulties. Also, in order to satisfy the diligence requirement under s. 227.1(3) a director must make more than inquiries of responsible directors — he must take positive steps to ensure compliance with s. 227.1(1). This is clearly shown in *Quantz* v. *M.N.R.*[34]

Mr. Quantz was an employee and director in charge of production and sales of caskets. The chairman of the board of directors and another director were responsible for the financial affairs of the company. The chairman relied upon the comptroller, who looked after payroll, for financial information. The appellant was aware that the company was in financial trouble but never made any inquiries about the company's ability to meet accounts payable. An auditor from Revenue Canada informed Quantz about his personal liability if employee deductions were not remitted. Quantz was assured by the chairman that the company was doing the best that it could. Quantz never pursued the matter of payments to the Receiver General any further. Revenue Canada assessed him under s. 227.1(1).

Mr. Quantz argued that he had exercised a sufficient degree of care, diligence and skill since his main function related to sales and not finances. The Tax Court rejected this argument. The court held that even though the appellant had always relied on the financial expertise of others, he had knowledge of the company's financial difficulties because he attended weekly meetings of the company. The appellant could not delegate s. 153 responsibility to other directors. Also, the appellant had an obligation not only to make inquiries, but also to take steps to prevent the failure of the company to make future remittances.[35]

The degree of diligence to be exercised does, however, have its limits. The test is not the degree exercised by a very cautious person who meticulously envisions the worst possible scenario, but that of

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[34](1988), 88 D.T.C. 1201, *per* Goetz T.C.J.

[35]These steps include giving instructions to the responsible person to ensure the payments are made to the Receiver General. Such action is particularly important where the director has been informed of the default by a Revenue Canada auditor. (1988), 88 D.T.C. 1201, *per* Goetz T.C.J., at p. 1205.

a reasonably prudent person in comparable circumstances. This standard becomes even more evident when a company's directors lose effective control of day-to-day operations and the flow of funds. This may be the case when the company makes an assignment in favour of the bank.

An example of this distinction is *Fancy* v. *M.N.R.*[36] Mr. and Mrs. Fancy were the only directors of an excavation company. The company expanded and prospered for 10 years with the assistance of bank loans. The company suffered a cash flow problem due to the recession of 1981 and disposed of some equipment. Mrs. Fancy was in charge of payroll and had not been late with any remittances for 12 years. The bank began monitoring all cheques and only authorized certain payments. As soon as the bank refused to authorize payment of remittances, Mrs. Fancy informed Revenue Canada. The directors were then assessed under s. 227.1(1).

The Tax Court allowed the appellants' appeals. The court held that the bank had effective control of the company's cash flow and could intervene any time that it believed its loans were in jeopardy. The court found that the appellants had not caused the company to divert any of its funds to other creditors to the detriment of the Minister. They resorted to efforts to raise funds to meet the statutory obligations of the company but unfortunately, the bank used these funds to pay down the line of credit. Clearly, the appellants had no effective control.[37]

The Minister argued that the appellants should have caused the company to cease operations as soon as they became aware of the serious financial problems. By continuing to operate, they accepted the risk of becoming personally liable under s. 227.1(1). The court rejected this argument. It held that liability under s. 227.1(l) was not absolute but conditional upon the directors' conduct in respect of circumstances linked to the company's failure to remit employee

[36](1988), 88 D.T.C. 1641, 71 C.B.R. (N.S.) 29, *per* Couture T.C.J.

[37]A director may be diligent if he relies upon a regular course of conduct which, in fact, for reasons beyond his control, becomes irregular. Failing to put the deductions into a separate account as required by s. 227(5) was not fatal to the s. 227.1(3) defence.

deductions.[38] In this case, their conduct exempted them from personal liability.

Prudence

Knowledge is an important factor to be considered when determining whether a director has exercised sound judgment. With respect to prudence, knowledge can be either actual knowledge or the knowledge that the reasonable person would have acquired in comparable circumstances. As usual, sound judgment can best be determined from hindsight. Thus, the balance between sound judgment and knowledge is risk of liability.

This dilemma can be seen in *Beutler* v. *M.N.R.*[39] Beutler and Salls were the only shareholders and directors in the company. The company was having financial difficulties and failed to make monthly employee remittances for several months. The company had a secured line of credit which had been unilaterally reduced by the bank. Salls tried to pay the outstanding remittances, but each time the bank failed to honour the cheque. As a result, the company agreed to assign accounts receivable to Revenue Canada to cover the outstanding debt. This was done, but the bank put the company into receivership and had priority over the assignments. Because there were insufficient assets to satisfy the amount owing under s. 153 of the Income Tax Act, the Minister assessed Beutler under s. 227.1(1).

Beutler argued that he had taken positive steps to correct the problems with Revenue Canada, but that the company's moneys at the bank were beyond his control. Unlike Fraser and Barnett, where the directors did not act, Beutler could not act. The Tax Court rejected the argument that s. 227.1(3) had been satisfied. It held that when the appellant and Salls tried to act to correct the problem it was too late. The appellant knew the monthly remittances had to be paid and that the company was using "government funds"

[38] The assignment of receivables to a lender is not evidence of the lack of diligence. However, the court clearly pointed out that such an assignment does not provide an automatic defence under s. 227.1(3). See, *supra*, footnote 34, at p. 1644.

[39] (1988), 88 D.T.C. 1286, *per* Brulé T.C.J.

as a loan because the cash flow was tight.[40] In addition, the company had not put the deductions in a trust account as required under s. 227(5).

In certain cases, prudence may compensate for personal attention to the financial affairs of a company and for the failure to put employee deductions into a trust account. In *Edmondson* v. *M.N.R.*[41], Edmondson invested money in a company. He became a director but had no idea what his duties were and even though he was a signing officer, he never attended the company offices or any directors' meetings. The company failed to make remittances of employee deductions. As soon as Edmondson became aware of his personal liability under s. 227.1(1), he invested more money in the company to ensure that Revenue Canada was paid. He also insisted, as a condition of making this further advance, that he co-sign all cheques and that his daughter become the company bookkeeper. Remittances were signed each month, but another director deliberately held back these cheques. The company went into bankruptcy and Edmondson was assessed for the arrears under s. 227.1(1).

The Tax Court allowed Mr. Edmondson's appeal. The court was impressed with his "good sense" in taking protective action when forced to do so. His actions were viewed as positive steps taken to ensure that Revenue Canada was paid. The court noted that the appellant was completely unaware of a director's duties, but nevertheless gave him the benefit of the exempting provision even though no trust account for deductions had been established.[42]

Knowledge must be considered as a factor in determining whether a director has exercised sound judgment. However, it is knowledge that introduces a risk factor to any decision when it is assessed after the fact. A director does not have to possess any greater knowledge than a reasonable person, but the actions taken by a director may be measured by the *knowledge* that another

[40](1988), 88 D.T.C. 1286, *per* Brulé T.C.J., at p. 1289. The evidence indicated that Mr. Beutler had consciously paid the monthly remittances and thus could not subsequently remedy the default by claiming he tried to prevent the failure by other actions.

[41](1988), 88 D.T.C. 1542, [1988] 2 C.T.C. 2185, *per* Brulé T.C.J.

[42]The court applied the dictum of Lord Denning in *Kiriri Cotton Co. Ltd.* v. *Ranchhoddas Keshavji Dewani*, [1960] A.C. 192. At p. 204, Lord Denning stated, "no man can excuse himself from doing his duty by saying that he did not know the law on the matter."

reasonable person would have *exercised* in comparable circumstances. This measurement may be detrimental to a director, particularly when the company subsequently loses control of its funds. An example of this is *Moore* v. *M.N.R.*[43]

Moore was the director of a company which was experiencing severe financial difficulties primarily caused by an employee work stoppage. The company had a secured line of credit with the bank. Because the line of credit was at its limit, the bank had taken full control over payment of the company accounts payable. The bank informed the company that it would not honour any cheque issued in respect of employee deductions. The bank subsequently called the loan and appointed a receiver. Revenue Canada issued a refund of corporation taxes, but the receiver applied this amount to pay down the secured line of credit. This refund, which Moore had intended to use to pay the outstanding arrears would have been more than sufficient for the purpose. He knew that the refund was pending at the time the company failed to make monthly remittances. Even though he felt that accounts receivable and work orders would meet company obligations, he was virtually powerless to ensure payment of any particular account. Moore was personally assessed for the amount owing to Revenue Canada under s. 227.1(1).

The Tax Court dismissed his appeal. The court noted that the appellant knew the payments procedure, the obligations to Revenue Canada, the financial strain the company was experiencing and the consequent limited financial flexibility imposed by the bank.[44] The court found that the appellant used and continued to use employee deductions as unauthorized credit from the Crown. To use these funds, which were to be held in trust as part of the company's working capital, was a highly questionable procedure. Intermingling trust funds with regular corporate funds was taking an unacceptable "risk" if remittances were not made on time.[45]

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[43](1988), 88 D.T.C. 1537, 69 C.B.R. (N.S.) 193, *per* Taylor T.C.J.

[44](1988), 88 D.T.C. 1537, 69 C.B.R. (N.S.) 193, *per* Taylor T.C.J., at p. 1540. The court suggested that directors, before consenting to the appointment of a receiver, should determine whether the financial institution is willing to pay outstanding remittances. Directors should avail themselves of this opportunity even if the answer is a foregone conclusion.

[45]*Ibid.*, at p. 1541. Despite the fact that the court dismissed the appeal, the appellant was given party and party costs. The court stated, at p. 1542:

Knowledge is not the only factor to be considered when determining whether a director has exercised sound judgment. Under the Income Tax Act, a director must also take steps to prevent the company's failure to deduct, withhold and remit. This obligation relates to both the diligence and prudence elements of the s. 227.1(3) defence. However, a director who exercises prudence may be excused from complying with the statutory requirement of placing employee deductions into a trust account when the company loses control over its funds. This is the case if a director has set up a system of employee deductions and remittances which has worked well in the past and has no knowledge of or control over remittances that have not been made.

The Tax Court of Canada so held in a well reasoned decision in *Merson* v. *M.N.R.*[46] Merson was a director of a company which was encountering a liquidity problem because of the dumping of a similar product on the Canadian market by a Japanese producer. The company filed a complaint under the anti-dumping legislation and eventually duties were levied against the Japanese product. During this period, however, the company had a fully extended credit limit with the bank. The bank sent two "financial advisors and consultants" to the company who were employees of Peat Marwick Ltd. They monitored the financial operations of the company and the bank only honoured those cheques previously approved by them. The only creditors to be paid were essential suppliers. Merson did not know that employee deductions had not been paid to Revenue Canada. The company had a procedure in place which had worked well until the arrival of the Peat Marwick Ltd. employees. During the relevant time, Merson was occupied with the anti-dumping case and was courting potential purchasers of the company. Under the terms of its security, the bank then had Peat Marwick Ltd. appointed as receiver and manager of the assets of the company. The receiver refused to remit the employee

"I do recognize that with a little more care and diligence Revenue Canada might have avoided this entire matter, by retaining this amount and using it as a set-off. After all, a main point at issue in this appeal, is an appropriate level for the exercise of care and diligence *by the appellant*, and one might carefully look at the *conduct of the respondent* also from that perspective.

[46](1988), 89 D.T.C. 22, [1989] 1 C.T.C. 2074, *per* Rip T.C.J.

deductions prior to its formal appointment. Merson was assessed for these amounts under s. 227.1(1).

Merson argued that once the employees of Peat Marwick Ltd. entered the company premises, effective control of the business operations was no longer with the directors. The bank's instructions were to defer remittances of employee deductions.[47] Also, before the arrival of the "financial advisors and consultants" the company had a good system to ensure timely remittances.

The court rejected the Minister's argument that *Moore* should
384 be applied, for three reasons. First, the appellant was not aware that the obligations to Revenue Canada were being left unattended because he was occupied in other business. Second, employee deductions and remittances were dealt with by an experienced and competent employee who had requested approval to make the payments but was refused.[48] Third, the appellant did not use or continue to use the unremitted source deductions as part of the working capital. In fact, these funds were maintained for the benefit of the bank.

The court distinguished the prudence required under s. 227.1(3) of the Income Tax Act from prudence required under s. 122(1)(*b*) of the CBCA. The distinction is based upon the source of the obligation. Under the CBCA, the duty is founded upon a director's obligation to the company whereas the duty under the Income Tax Act is a statutory obligation. The difference relates to risk.[49] A director who manages a business is expected to take commercial risks for the benefit of the company. Under the Income Tax Act, however, the degree of prudence required leaves no room for risk.[50] The degree of prudence required for s. 227.1(3) does not require an unduly excessive level.

This distinction is important because it better accommodates modern commercial practice. Merson had put in place a system with

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[47] It was clear that, after the receiver was appointed, the bank took all possible measures to ensure that its security took priority over amounts owing to Revenue Canada.

[48] In this case, unlike in *Barnett* and *Fraser*, there was no question of delegation of duties. What was in issue was the adequacy of the actions taken in light of the knowledge available at the time of the default.

[49] *Merson*, *supra*, footnote 44, at p. 28.

[50] See, *supra*, footnote 19.

respect to employee deductions and remittances which worked well and thus, it was only reasonable for him to assume it would continue to do so until informed otherwise. Effective lines of communication were in place to ensure that the company did not fail in its obligations. The sudden refusal to approve the cheque for the remittance, coupled with the stress from the presence of outside monitors and diversion of Mr. Merson's energies to other important company business reasonably explained why he did not know of the company's failure to remit. To hold otherwise would have required an unduly excessive measure of prudence not contemplated by the Income Tax Act.[51]

The court also rejected the Minister's argument that the appellant did nothing to prevent the company's failure to remit source deductions. The appellant did not cause the company to put the source deductions into a trust account as required under the Income Tax Act. The court held that the appellant did perform a positive act by causing and allowing to remain in existence a system that worked well and was not likely to fail. In order for a person to be in a position to prevent an omission, that person must know, or reasonably should have known, that the omission would occur. In this case the appellant was not in a position where circumstances would have permitted him to acquire such knowledge prior to the failure to remit.[52] When the appellant finally did learn of the company's failure, he was not in a position to have the company make the payments.

Prudence, therefore, is measured by determining whether a director exercised sound judgment. In order to do this, the knowledge that a director possessed, or should have possessed, will be important. At the same time, what a director knows, and when it is known, must reflect the realities of modern commercial practice. The court is willing, as seen by *Merson*, to be reasonable in the level of knowledge required when circumstances warrant.

[51]Rip J. stated, *supra*, footnote 44, at p. 29, "The only way he could have been aware of the failure at the time, in the circumstances, was to have conducted himself at a level of prudence not contemplated by the Act or corporate legislation."

[52]This is the prime distinction between *Moore* and *Merson*.

Authority

In corporation law, authority is fundamental to a director's position.[53] Without authority, a director cannot act. A corporation cannot bind or be bound to a third party without authority.[54] Authority, however, is given to the board of directors which is responsible for the supervision and management of the affairs of the corporation.[55] A director can only exercise authority delegated by the board of directors.[56] Authority is central to what a director can and cannot do.

Authority is assumed by s. 227.1(1) of the Income Tax Act because the persons who are vicariously liable for the corporation's default are the directors. There are two reasons why the directors are liable. First, they are easily identified. Second, the directors have the authority to cause the corporation to comply with its statutory duties and the directors themselves may be the cause of the corporation's default. An exemption from personal liability is given to directors who exercised their authority to prevent the failure of the corporation to make timely remittances.

The assumption made in s. 227.1(1) is that the position of director always carries with it authority to act. This is not always

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[53]At common law, a director was treated as an agent of the corporation and thus only had those powers specifically conferred by the corporate principal through the board of directors. See, *Gower's Principles of Modern Company Law*, 4th ed. (London, Stevens & Sons, 1979), p. 143. Modern legislation reaffirms that the powers of a director are based upon principles of authority but restricts the corporation's defence of lack of authority as a means of excusing itself from its obligation to third parties. See, CBCA, s. 18 and OBCA, s. 19. Note also that the common law doctrine of *ultra vires* is no longer applicable as defence against unwary creditors because the corporation has the capacity of a natural person. See, CBCA, ss. 15, 16 and 17 and OBCA, ss. 15, 18 and 194.

[54]CBCA, s. 115(1), OBCA, s. 127(1). Modern legislation has adopted the "Indoor Management Rule" whereby a person dealing with a corporation is entitled to assume that all internal arrangements conferring authority upon corporate directors, officials and agents have been complied with. CBCA, s. 18, OBCA, s. 19. However, these provisions provide exceptions when the third party, "has, or ought to have, by virtue of his position with or relationship to the corporation, knowledge" that the agent lacked the requisite authority. See also, CBCA, s. 116 and OBCA, s. 128.

[55]CBCA, s. 102, OBCA, s. 115. Both Acts make provision for unanimous shareholder agreements. Under s. 227.1(1) of the Income Tax Act shareholders privy to such an agreement but not on the board of directors are presumably not vicariously liable for corporate defaults under s. 153.

[56]CBCA, s. 115, OBCA, s. 127.

correct. Authority to exercise the powers of the corporation is vested in the board of directors and only the board has this authority at a properly constituted meeting.[57] Further, when the board is comprised of two or more directors, an individual director may be precluded from doing what he or she believes to be the right thing because he or she is in a minority. This possibility is particularly relevant within s. 227.1(3), which obliges the individual director to take positive steps to prevent the corporation's default.

The application of authority principles to the corporate structure often creates confusion. *Cybulski* v. *M.N.R.*[58] is an example. Cybulski and another were the only directors and shareholders in a sanitation company. The company encountered financial difficulties and the relationship of the two directors deteriorated. Cybulski resigned as director and secretary-treasurer of the company. This resignation was accepted by the remaining director. It was agreed that Cybulski's shares would be transferred to another person. After his resignation, the company failed to make remittances under s. 153. Prior to his resignation, Cybulski ensured that remittances were made and often spoke to the company's bookkeeper about their importance. The Minister assessed Cybulski for the defaults under s. 227.1(1).

The Minister argued that Cybulski had never resigned from the company. Under the Ontario Business Corporation's Act, the resignation of a first director is not effective until a successor is elected or appointed.[59] Cybulski was still listed in the directors' register in the company's minute book at the time of the default.

The Tax Court noted that Cybulski played no role in the affairs of the company after he thought he had resigned. The remaining director treated him as an "outsider." The court also noted that Cybulski did not know of the company's failure to remit employee deductions. The court was satisfied that the evidence would have

[57]There are basically three requirements that must be complied with before a meeting of the board of directors is properly constituted. There must have been timely and proper notice [CBCA, s. 114(5), OBCA, s. 126(9)], a quorum of directors [CBCA, s. 114(2), OBCA, s. 126(3)] and compliance with residency requirements [CBCA, s. 114(3), OBCA, s. 118(3)]. Also, a written resolution signed by all directors entitled to vote is as valid as if it had been passed at meeting of directors. [CBCA, s. 117(1), OBCA, s. 129].

[58](1988), 88 D.T.C. 1531, *per* Christie A.C.J.T.C.

[59]OBCA, ss. 119(2), 121(2).

supported his resignation except for the OBCA restrictions.[60] The court made no finding as to whether the resignation was effective. Instead, the court held that Cybulski was relieved of liability under s. 227.1(3) because he had reasonable grounds for believing that he had severed his connection with the company. The court was of the opinion that a taxpayer need not always take positive steps to satisfy the statutory requirement that a director must exercise a degree of care, skill and diligence.[61]

The court's reasoning in *Cybulski* is open to question because it fails to discuss adequately the question of a director's authority under the OBCA. The Act makes provision for an orderly change of directors.[62] However, in order that quorum requirements are met so that the board of directors can exercise the powers of the corporation, none of the first directors is permitted to resign unless, at the time the resignation is to become effective, a successor is elected or appointed.[63] Without a quorum, a meeting of the board is not properly constituted and any business transacted at that meeting is not binding on the corporation.[64]

The purpose of this restriction is to assure outsiders that any dealings that they might have with the corporation are binding upon it.[65] Third parties have no way of knowing whether a particular transaction has been approved at a properly constituted board of directors' meeting.[66] The OBCA gives this assurance to outsiders dealing with the corporation under threat of penalty for non-compliance with the Act.[67] These are matters relating to authority as a guarantee to the shareholders that a board of directors will act properly.

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[60] *Supra*, footnote 56, at p. 1534.

[61] This position is difficult to understand because the words "to prevent the failure" within s. 227.1(3) surely assume that some action must be taken with respect to s. 227.1(1).

[62] OBCA, s. 119(4) to (8), 121, 122 and 124, and CBCA, s. 106(3) to (7), 108, 109 and 111(1).

[63] OBCA, ss. 119(2) and 121(2). There is no equivalence of s. 119(2) in the CBCA.

[64] CBCA, s. 144(2), OBCA, s. 126(3).

[65] *Supra*, footnote 53. This restriction is also for the protection of shareholders.

[66] *Supra*, footnote 55.

[67] OBCA, s. 257(1)(*i*).

The authority assumed in s. 227.1(3) is, however, quite different. This authority deals with the exercise of corporate powers and the ability to influence the management of a corporation. Indeed, it is only through the exercise of such powers that a director can take steps to ensure compliance with s. 227.1(3). These powers are the ones delegated by the board to individual directors.

In the present case, after Cybulski's departure from the company, he ceased being a director within the meaning of s. 227.1(1) of the Income Tax Act.[68] He did not exercise any of the corporate powers. He no longer had any influence over corporate management. He was regarded as an "outsider" by corporate personnel and was refused general information about the company even as a shareholder. Further, he was in no position to take steps to prevent the corporation's default, which is a requirement of the s. 227.1(3) defence.[69]

[68]In Directive CA 87-67, October 6, 1987, Revenue Canada has taken the position that there should be no distinction between active, passive, nominee, outside and *de facto* directors. It is doubtful however whether passive directors would be personally liable under s. 227.1(1).

[69]In his judgment Christie A.C.J.T.C. quoted from Iacobucci, Pilkington and Prichard, *supra* footnote 15, at p. 287,

"The common law standard of care and skill which a director must meet is generally expressed as an objective standard: he must exercise the reasonable care and skill which an ordinary person might be expected to exercise in the circumstances on his own behalf. However as Mr. Justice Romer indicated, in the leading case of *Re City Equitable Fire Insurance Company* ... the common law standard is also partly subjective: a director need not exhibit a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. At common law the degree of care and skill demanded of a director varies with the type and size of the company he serves."

Even though his Honour notes that the new statutory standard applies the objective test, several subsequent cases have used this passage as authority for the proposition that the current standard is both objective and subjective. See, *Edmondson* v. *M.N.R.* (1988), 88 D.T.C. 1542 at p. 154, [1988] 2 C.T.C. 2185; *Fancy* v. *M.N.R.* (1988), 88 D.T.C. 1641 at p. 1644, 71 C.B.R. (N.S.) 29; and *Caya* v. *M.N.R.*, unreported, Tax Court of Canada, 1988, 86-1261 (IT), *per* Brulé T.C.J. at p. 3 of the Judgment. The correct position was clearly stated by Kempo J. in *Wilson* v. *M.N.R.*, unreported, Tax Court of Canada, 1988, 87-1207 (IT). She clearly rejected the application of the subjective standard. At page 3 of her Judgment, she stated:

"As I see it, the Appellant's purported answer to any liability in this matter rests on an almost exclusively subjective approach to subsection 227.1(3) exculpation. That is, the absence of care, diligence and skill on the part of a person who believed he was not a director was precisely what a reasonably prudent person in comparable circumstances would have done. Firstly, this ignores the Appellant's own carelessness in this respect. Secondly, this position purports to expand or enlarge the exculpatory provision by the introduction of a purely subjective test as to the directorship status per se. If that is the case, I find no support in subsection 227.1(3) for that interpretation.

Unless otherwise provided in the corporation's by-laws, board of director's decisions are determined by a majority vote. Those who are in a minority must live with the decision of the majority.[70] This position will offer little comfort to individual directors who try to take steps to ensure the company's compliance with s. 227.1(3) but are outvoted by other directors on the board. A director's power to take independent action is assumed in s. 227.1(3).

This dilemma was recognized in *Caya* v. *M.N.R.*[71] Caya and three others were on the board of directors of a company which owned and operated a hotel. He had difficulty convincing his co-directors to adopt sound business practices. The others resisted when he found a buyer for the company and instead, appointed another company and then one of their number to manage the hotel. The company became delinquent in its remittances to Revenue Canada. Caya objected to the manager's method of operation, but was overruled by the majority. He met with Revenue Canada which set forth a proposal and was assured by the manager that it would be followed. Caya arranged a line of credit to pay Revenue Canada but the other directors would not co-operate in the giving of personal guarantees. The manager-director who controlled the company accounts did not make the remittances even though Caya attempted to convince him that these payments were mandatory. Caya was assessed for the company defaults under s. 227.1(3).

The Tax Court allowed the appeal. The court noted that Caya attempted to obtain more capital to pay off creditors as soon as he became aware of the financial difficulties. Further, he was deceived by the director-manager. The court held that Caya had taken positive action to prevent the company's failure to remit employee deductions but that as a minority shareholder and without the backing of other shareholders, there was little he could do.[72]

Presumably the same reasoning applies when a director does not have the support of the other directors. It is submitted that Caya was correct, in practical terms, in not resigning from the board because then he would have lost all possible impact upon the management of the company. While his actions were rebuffed by

[70] A director is entitled to have his dissent noted, CBCA, s. 123(1), OBCA, s. 135.

[71] *Supra*, footnote 67.

[72] *Supra*, footnote 67, at p. 5 of the Judgment.

the majority of directors, they did constitute positive steps within s. 227.1(3) and hence afforded him protection from personal liability. It is true that Caya would not have been liable as a shareholder, but staying on the board was the only means by which he could protect his sizeable investment.

Conclusion

The parameters of acceptable conduct for exemption from liability under s. 227.1(3) have not been definitively drawn. Attentive care, vigilance and sound judgment are essential to the defence. In corporate terms, this means establishing proper procedures to ensure compliance with s. 153 obligations and the constant monitoring of these procedures to ensure continuing compliance. Central to the diligence defence is whether the director knew a default had occurred and his timely reaction to it. Although authority to act is important in the corporate context, it is usually a consideration of lesser importance with respect to s. 227.1 liability.

The civil liability of directors for a corporate default is important for other reasons. Section 227.1(1) liability may be viewed as merely another example of a director's vicarious liability for the default of a corporation's statutory obligations.[73] Each additional obligation creates a greater risk of non-compliance and hence of directors' liability. As a consequence, premiums for liability insurance will rise. This cost will have an ultimate impact upon consumers or shareholders in the form of higher prices or smaller profits. On the other hand, by Revenue Canada assessing directors personally, creditors may benefit in the event of financial difficulties of the corporation. The effect of directors' liability, then, is to shift the loss from the Crown to others who may have received a benefit from the company's breach.

There is, however, an important impact upon the director's position as a result of the s. 227.1(1) liability. This is the recognition that a director can no longer automatically rely on the corporate veil to shield him from personal liability for the company's

[73]For a comprehensive listing, see J.M. Wainberg and Mark I. Wainberg, *Duties and Responsibilities of Directors in Canada*, 6th ed. (CCH Canadian Ltd., Don Mills, 1987), p. 29.

debts.[74] This traditional defence has been primarily eroded by statutory intervention which employs the common law principle of vicarious liability as the mechanism for personal liability of a director. As a consequence, a director is more personally accountable for his/her actions.[75]

This higher standard of conduct can be viewed as the legislative response to the low standards of care, diligence and skill imposed by the courts at common law. However, the court's vision of directors' fiduciary duties will continue to be critical when applying legislative provisions.

[74]Shareholders are afforded statutory protection against corporate liabilities. See CBCA, s. 45 and OBCA, s. 92.

[75]Laskin J. was of the opinion that high standards of conduct might result in the strict application of a director's fiduciary duties. In *Canadian Aero Service Ltd.* v. *O'Malley*, [1974] 1 S.C.R. 592 at p. 610, 40 D.L.R. (3d) 371, he stated, "It is a necessary supplement, in the public interest, of statutory regulation and accountability which themselves are, at one and the same time, an acknowledgment of the importance of the corporation in the life of the community and of the need to compel obedience by it and its promoters, directors and managers to norms of exemplary behaviour." Clearly, legislators have taken the lead in determining the norms of behaviour.