

Directors' duties/ liabilities on insolvency

By Darren D. O'Keefe

WHEN A CORPORATION IS approaching insolvency, it is important that the directors and officers of the corporation have a clear and absolute understanding of their relevant duties and liabilities. Such an understanding will be necessary for the directors and officers to properly protect themselves from those personal liabilities associated with the corporation's actions or inactions. Therefore, directors should explore their potential liabilities, as well as possible ways they may limit their liability on corporate insolvency.

THE BASICS: LEGAL DUTIES OF DIRECTORS

Generally, as stated in the *Canadian Business Corporations Act* and the *Corporations Act (Newfoundland)*, directors are responsible for directing the management of the business affairs of a corporation. In discharging this duty, directors must act honestly and in good faith with a view to the best interests of the corporation. Further, directors owe a "fiduciary" duty to the corporations they serve. Directors have a duty to:

- Avoid conflicts of interests;
- Not to use his/her position as director for personal gain;
- Keep corporate information confidential, and;
- Serve the corporation loyally, selflessly and honestly.

Unlike their duty to the corporation, directors do not owe a fiduciary duty to the corporation's creditors. However, when a company is insolvent (or nearly so), a director may owe some duty of care to a variety of new parties related to the corporation, including the company's creditors. In fulfilling their statutory duties to the corporation, directors may have an obligation to at least consider the interests of the corporation's creditors.

THE NEXT STEP: DIRECTORS' LIABILITIES

As a basic set of obligations, under the *Corporations Act*, where a director authorizes the payment of a dividend, the issuance of a share or an illicit loan on the corporation's behalf, the director is jointly and individually liable (to restore to the corporation amounts so distributed or paid



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and not otherwise recovered by the corporation). In addition to the basic liabilities of directors under the *Corporations Act* and the *Canadian Business Corporations Act*, the following are examples of liabilities of directors codified under statute:

Employee wages

Section 37.3 of *Newfoundland's Labour Standards Act* states that the directors of an employer corporation are jointly and individually liable for the unpaid wages of an employee where the employer corporation becomes insolvent.

Income tax and wage deductions

The federal *Income Tax Act* (the "ITA") requires a corporation to deduct or withhold certain amounts from payment of employee wages, and to remit those amounts to the government. If a corporation fails to do so, its directors are then jointly and severally liable to pay the amounts, along with any related interest and/or penalties.

Similar to the related provisions of the ITA, under the *Employment Insurance Act*, the *Canada Pension Plan*, the *Pension Benefits Act*, and the *Excise Tax Act*, an employer must deduct prescribed amounts from employee wages. Should the corporate employer fail to do so, the directors

are jointly and severally liable for those amounts that they failed to deduct.

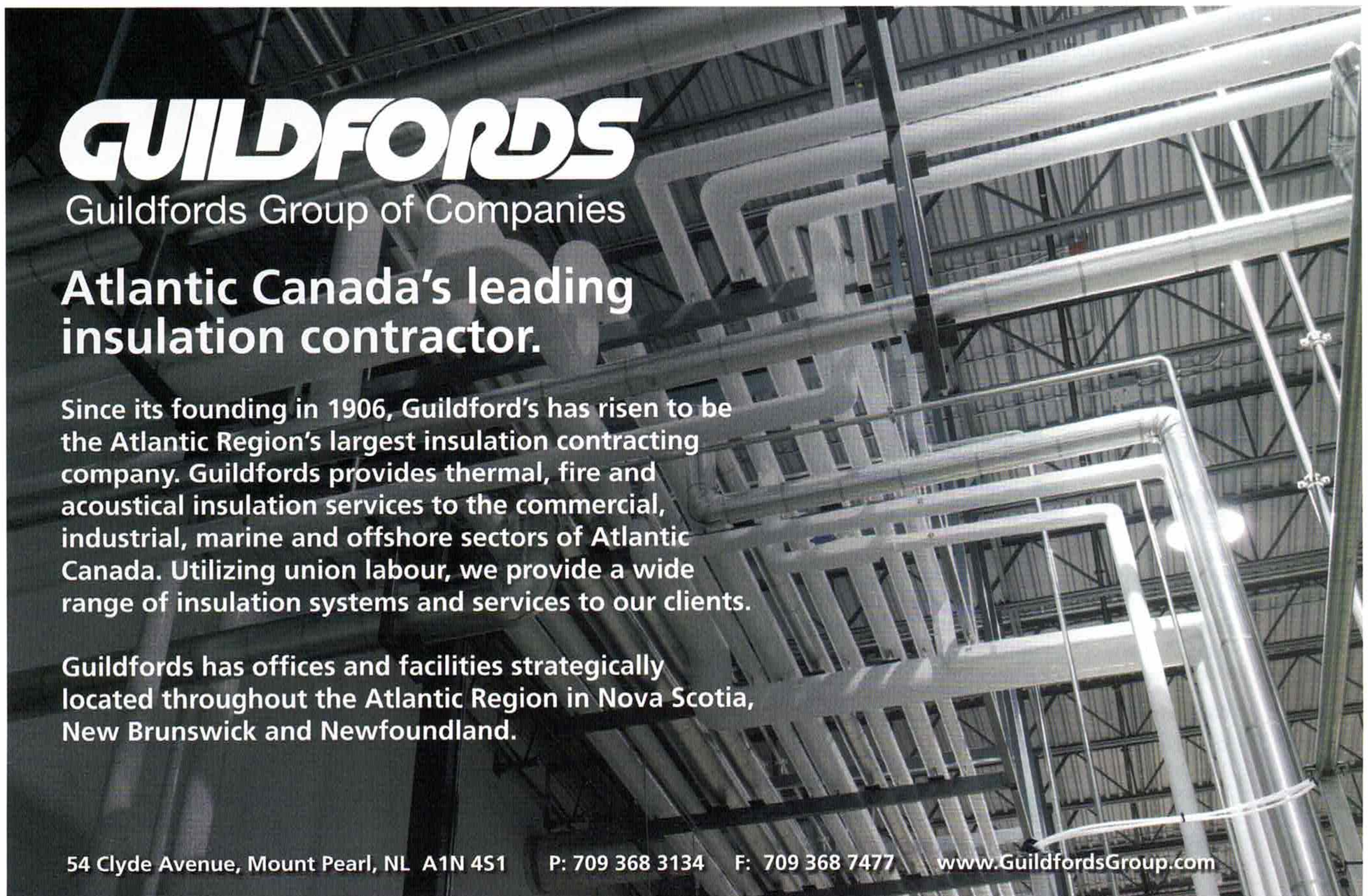
Bankruptcy and Insolvency Act (the "BIA")

Directors or officers may be liable if they participated in a transaction where, in the year preceding the bankruptcy, the corporation sold property for a price conspicuously greater or less than the fair market value. Further, under the BIA, where a corporation is bankrupt, directors may be liable where the corporation paid dividends while insolvent if he/she failed to perform the obligations imposed on the bankrupt corporation.

CONSIDERATIONS FOR DIRECTORS WHERE A COMPANY FILES FOR CREDITOR PROTECTION

Directors' and Officers' Charge (the "D&O Charge")

A D&O Charge is a tool used to convince directors to stay in their role while a company seeks creditor protection such as a BIA proposal or under the CCAA. The D&O Charge is a court-ordered priority charge on the assets of a company. It can be used to indemnify the directors from obligations that they may incur following commencement of the creditor protection proceedings.



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Director and officer liability insurance

A corporation may purchase and maintain insurance for the benefit of its directors and officers to protect against any liability incurred by such individual in that individual's capacity as a director or officer of the corporation. When a company is entering creditor protection, the directors should ensure that such insurance is maintained. In general, the coverage afforded by such policies extends only to reimburse a director or officer for the consequences of honest mistakes.

PROTECTION TIPS

The following is a non-exhaustive list of things that directors can consider in order to minimize their potential personal liability when a corporation is in the zone of insolvency:

- Seek external counsel from both financial and legal advisors.
- Stay informed, and keep up-to-date with the corporation's latest financial information.
- Be fully aware of the fiduciary duties they owe to the corporation and its

various stakeholders.

- Stay informed of the applicable legislation and the different sources of potential liability.
- Hold regular board meetings and ensure that the decisions taken and the reasoning behind those decisions are fully documented.
- Make sure that the corporation's governing documents provide for the corporation to indemnify directors and officers for their official actions.
- Ensure that the corporation obtains adequate directors' and officers' liability insurance.
- Ensure that the corporation has met and continues to meet its

ongoing obligation in respect of its remittances of taxes.

- Ensure that the corporation has paid all amounts to employees for wages, etc.
- Ensure that the corporation has met and continues to meet its ongoing obligations in respect of deductions and remittances under pension and employment insurance statutes.
- On the bankruptcy of the company, consider formally tendering your resignation as a director (and updating the Registry of Companies filing) to trigger the commencement of limitation periods applicable to certain Canada Revenue Agency claims. ♦

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