



business meeting

BECOMING A CORPORATE DIRECTOR — THE RESPONSIBILITIES AND THE RISK

In Canada, companies can be incorporated at either the federal or provincial level, and at either level, incorporation offers many advantages. Corporations have a separate legal existence from their shareholder owners, and therefore provide those owners with protection from liability for actions or negligence of the corporation. There are also tax advantages to incorporation, as corporate tax rates, especially for smaller businesses, are generally lower than those imposed on individuals. As well, incorporation provides the business with a continuous existence and allows the business to be owned by more than one individual—a benefit for a sole proprietor or the partners who want to pass the business on to the next generation.



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Whether the incorporation is federal or provincial, and whatever the reason for incorporating a business or the kind of business it is, the rules governing the structure and operation of that corporation are largely the same. And one of the invariable rules requires every corporation—large or small—to have a least one director.

Who can be a corporate director?

Each corporation can choose the number of directors who sit on its board (or, more typically, can set a minimum and maximum number of directors) and that number, along with other details of the corporate structure, are outlined in the company's Articles of Incorporation. While it's possible to have just a single director, this would usually be the case only for the smallest of companies.

To become a corporate director, a person (and it must be a person—a corporation cannot be a corporate director) must be at least 18 years of age, must be of sound mind (that is, must not have been declared incompetent by a court), and must not be currently in bankruptcy. It's not actually necessary for a director of a Canadian corporation to be a Canadian, but the rules require that at least 25% of the directors of any Canadian corporation be Canadian residents. Where a corporate board of directors has fewer than three members, at least one of those directors must be a Canadian resident. Directors can be elected for terms of up to three years, but where the corporation's governing documents don't specify a fixed term, a director holds his or her position until the next meeting of the shareholders of the company, at which time he or she may be re-elected. Shareholders' meetings are held annually.

Finally, the law does not actually require that a director own shares of the company on whose board he or she sits. The company can, however, require directors to own corporate shares as a precondition to holding a position on the board.

First Board of Directors

When a business applies to Corporations Canada for a certificate of incorporation, it must provide both the Articles of Incorporation for the new company and a First Board of Directors form.

The First Board of Directors form lists the names and addresses of the initial members of the board of directors of the corporation, and indicates whether each of them is a Canadian resident. The responsibilities of these directors begin on the date Corporations Canada issues the Certificate of

Incorporation for the new company and ends at the first meeting of shareholders, when the shareholders elect the corporation's directors. Elected directors may be chosen from the first directors or one or more of those directors can be replaced.

The responsibilities of corporate directors

The picture that many Canadians have of corporate directors is that of a highly paid director of a blue chip multinational, travelling on the company jet to attend directors' meetings in exotic locations. While there are certainly corporate directors who fulfill that perception, the reality is most Canadian companies are small or medium-sized owner-managed businesses. In such small operations, it's not unusual for family members or friends to be asked to become directors of the company, often as part of the First Board of Directors. In other instances, someone may agree to sit on the board of a local non-profit organization, as a way of supporting the activities of that organization. While many directors, especially first-time directors of small companies, view their position as purely nominal or honorary, the fact is that taking a position as a corporate director means taking on very real responsibilities. And, no matter what size the company or organization may be, the responsibilities of those directors are the same.

Directors are responsible for the overall governance of the company. While they are not typically involved in the day-to-day management of company business, they appoint and oversee the corporate officers (the chief executive officer, chief financial officer, etc.) who do make the important day-to-day decisions. As well, directors of a company have the power to make significant changes affecting the structure and direction of the company, and many of those decisions can be made with no need for approval by the shareholders. For instance, a company's board of directors can approve financial statements of the business and can change the company's by-laws and Articles of Incorporation, which determine the corporation's structure and the rules which govern the operation of the corporation. By-law changes must ultimately be approved by the company's shareholders at the next regular shareholders' meeting.

The authority which directors possess over the conduct of corporate affairs is matched by the responsibility they bear for actions taken by the company. In general, the directors have what is termed a "fiduciary" duty toward the company. In practical terms, having such a duty requires the directors to put the interests



of the company above their own. For instance, where there is a business opportunity available to the company, any of the directors of that company are precluded from pursuing that business opportunity for their own benefit or that of another company.

Overall, directors are expected to act honestly and in the best interests of the company, and to exercise at least the level of care and diligence that a reasonable person would exercise in similar circumstances.

While directors are ultimately responsible for all facets of company operations, there are some areas which cause more difficulties for directors than others. The one which most often results in personal liability for directors is the obligations which the company owes to the Canada Revenue Agency (CRA).

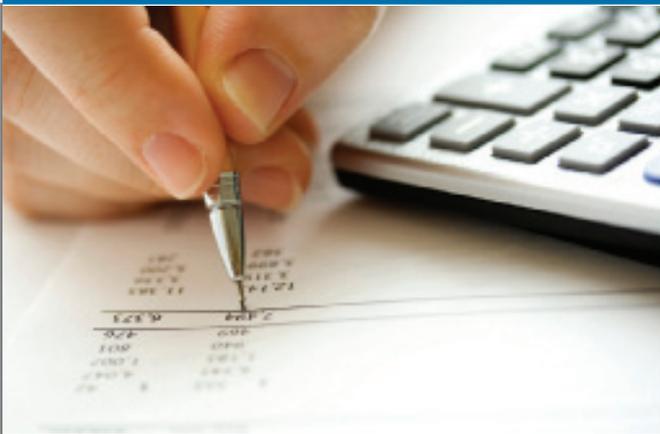
What is a director's potential liability?

A company, depending on its size and the industry in which it operates, can have a variety of legal and tax obligations, with the latter usually including the obligation to remit amounts on a regular basis to the federal government. Again, depending on the industry and activities of the corporation, those remittance obligations can involve excise duty, refundable tax for scientific research and experimental development, or share-purchase tax credits or payments to non-residents. Corporate directors can be held liable for a company's failure to remit any or all such amounts. However the one remittance obligation common to virtually

all companies is that of remittance of employee source deductions. Any corporation which has employees must withhold income tax, Canada Pension Plan contributions, and Employment Insurance premiums from the employees' wages, and must remit those amounts, together with any required employer contribution, to the CRA on a regular basis. It's not surprising, therefore, that the majority of cases in which directors have been held personally liable for a corporation's failure to remit have involved employee source deductions. And, when a failure to withhold or remit source deductions has occurred, the obligations of directors generally come down to the following four questions.

- Who can be held liable?
- What can they be held liable for?
- How can liability be avoided?
- What are the potential consequences where liability is established?

The actual mechanics of making source deductions and remitting them to the CRA on time is a function usually carried out by a company's payroll department or, in smaller companies, a bookkeeper or accountant. While company directors don't have to be directly involved in that process, what they must do is to make sure that the company is properly withholding deductions or, in the CRA's words, they "must make every reasonable effort to ensure that source deductions ... are withheld, collected, remitted and paid." That reasonable effort is part of the director's "due diligence" responsibility—the director's obligation to



take the care that a reasonably prudent person would take in similar circumstances to make sure that the corporation deducts, withholds, collects, remits, and pays amounts due on a timely basis.

Numerous court decisions have addressed the question of just what constitutes “due diligence” on the part of a corporate director, and the CRA has summarized that duty, as it relates to corporate remittances, as follows.

To ensure that he or she has fulfilled the due diligence obligation, a corporate director should use methods such as:

- establishing a separate account for withholdings from employees and remittances of source deductions and other amounts owed to the CRA;
- calling on financial officers of the corporation to report regularly on the status of the account; and
- obtaining regular confirmation that withholdings, remittances, or payments have in fact been made during all relevant periods.

In practical terms, a corporate director could fulfill this responsibility by requiring the company employee who looks after source deductions and remittances to set up a separate account in which source deductions are deposited, and to provide a regular report to the Board of Directors, with documentary evidence in the form of receipts and/or statements of account from the CRA, confirming that all source deductions have been made and remitted as required. A director who does so is very likely to be seen to have made all reasonable efforts to ensure that the company is in compliance with its obligations.

Where there is a failure to meet those obligations, however, the CRA will look first to the company to make good on any deficiency. It is only where the company is unable to do so—a judgment against the corporation cannot be realized on, or the company

has been dissolved or liquidated, or is bankrupt with no assets to pay its obligations—that the CRA will advise the directors with a “pre-assessment proposal” that they may face liability for the company’s outstanding debts. A director who receives such a communication from the CRA should respond in writing within the time frame set out in the proposal, outlining the steps which he or she had taken to ensure that the corporation was in compliance with its obligations, and should provide documentary evidence of the steps taken. The CRA will then consider that response before deciding whether to issue an assessment against the director personally for amounts owed by the company to the CRA.

Where a company is in arrears with respect to employee source deductions and remittance of those deductions to the CRA, it’s often because the company is itself in financial difficulty. And, as those financial difficulties increase, other corporate financial obligations may go unpaid including, sometimes, employee wages. Where that happens, employees can look to the directors of the company for payment of up to six months’ worth of unpaid wages.

How a director’s liability is determined—understanding joint and several liability

Where directors are held personally responsible for corporate debts, that liability is “joint and several”, meaning that each director can be assessed for the full amount of any amount owed by the company to the CRA, including penalties and interest—assessments for such debts are not issued on a pro rata basis. That being said, each director who is found liable for and pays corporate debts is entitled to look to the other directors for compensation to the extent of their share in the debt.

Who is a corporate director?

Given the detailed requirements the law imposes for the appointment and election of directors, it may seem odd to ask who is a corporate director. However, it’s possible for someone to be held liable for corporate obligations even when that person has never actually been elected to sit on the Board of Directors.

In the CRA’s view, the net of potential directors’ liability is cast very, very broadly. Or, in the CRA’s wording, “[T]he statutes do not distinguish between directors, whether active, passive, nominee or outside directors.” Anyone who holds the title of director can face personal liability for the company’s failure to fulfill its obligations to the CRA.

It's a common misconception that a director who is not involved in the affairs of the company—who doesn't, for instance, attend directors' meetings, read minutes of the meetings, or sign directors' resolutions—can't be held liable for decisions made at meetings he or she didn't attend or implemented through resolutions of which he or she was unaware. In fact, the opposite is true—not only does a lack in involvement in the affairs of the company generally not absolve a director of potential liability, that very lack of involvement can be seen as evidence of a failure to meet the obligations that come with a position as a company director. And, finally, it's not even necessary to formally hold a position as director in order to be held liable for company failures. The CRA's position is that “[O]fficers, employees and others who are not legally appointed or elected as directors, but who perform the functions that directors would perform, may be liable.”

Directors' and officers' insurance

A few decades ago, a position on a company's board of directors was seen as something of a sinecure—a job which required little actual work but for which the compensation could be quite generous.

A number of changes over the past decade or so have changed that perception. Several high profile corporate bankruptcies and/or frauds, and the resulting losses sustained by shareholders, employees (past and present), and corporate creditors have led to a renewed focus on the responsibilities of directors and the extent to which they fulfill those responsibilities. As well, a new level of shareholder activism has meant that, more than ever, directors are being held to account where wrongdoing or negligence by corporate officers has been shown to have taken place on the directors' watch.

One of the by-products of that increased scrutiny and potential liability has been a greater reluctance by qualified individuals to become corporate directors, or at least a desire on their part to seek assurances that measures have been put in place to protect them from certain liabilities. The corporation is entitled to provide such assurances, which may include one or more of the following measures identified by Corporations Canada:

- purchasing insurance to protect directors and officers against liabilities incurred in the exercise of their duties;

- agreeing to compensate directors and officers for losses they may suffer or costs they may incur while carrying out their duties—except where the director or officer has failed to act honestly and in the corporation's best interests; or
- in certain circumstances, advancing funds to directors and officers to help them pay the costs of defending themselves in legal actions brought against them. Note, however, that in cases where directors or officers fail to defend themselves successfully, they are required to repay the corporation for these advances.

Leaving the Board – how long does liability last?

While a director's potential liability for amounts owed by the corporation to the CRA is significant it's not, fortunately, open-ended. The CRA must issue any assessment against a director within two years of the time that a director resigned his or her position with the company. So, in other words, leaving a position as a company director will not insulate that director from liability for actions or omissions with respect to corporate tax and remittance obligations which occurred during his or her time as director. However, any assessment in respect of those actions or omissions must, in order to be valid, be issued by the CRA within two years after the date the director resigned.

Most corporate directors, whether in large, small, or medium-sized companies, will never face the prospect of being held personally liable for amounts owed by the corporation to employees or to the CRA. Nonetheless, anyone who agrees to act as a corporate director for a company of any size, or for a non-profit organization, should understand that such a position is never simply a nominal or honorary one. Becoming a corporate director means taking on very real ongoing responsibilities and ignorance of or failure to take seriously those responsibilities will not serve as a defence to any potential personal liability.

The CRA's recently updated and re-issued its publication on the obligations and potential liabilities of corporate directors, and that publication, Information Circular IC89-2R3, is available on the CRA website at <http://www.cra-arc.gc.ca/E/pub/tp/ic89-2r3/ic89-2r3-14e.pdf>.