

LEGAL AND FINANCIAL LIABILITY OF DIRECTORS OF ONTARIO AND CANADIAN FEDERAL BUSINESS CORPORATIONS

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The decision to become a director of a corporation established under the *Ontario Business Corporations Act* (OBCA) or *Canadian Business Corporations Act* (CBCA) should be very carefully considered as it may expose a person to substantial personal legal and financial liability which may outweigh any benefits and prestige of being a director. A director may become liable to (1) the corporation itself, (2) the employees of the corporation, or (3) the third parties. Some types of liability may even be quasi-criminal in nature and it may be hard for directors to defend themselves against some types of liability (for example, liability to employees for unpaid wages), if certain conditions are met.

With respect to all types of liability, directors are considered “fiduciaries” of the corporation and must act in its best interest. Their liability is different from that of the corporation’s shareholders as the latter may act, and very often do, purely in their self-interest with the sole purpose of increasing the value of their investment. While shareholders may engage in transactions which are contrary to the corporation’s interests, directors may not, and, if a conflict of interest arises, directors must officially disclose their conflict to the other directors of the corporation and refrain from voting on such matters at meetings of the board of directors. If directors do not disclose such a conflict and profit from the transaction at the expense of the corporation, they may be sued for the profits made or for the corporation’s losses.

In addition to the common law “fiduciary” duty, there are numerous instances listed in the OBCA, CBCA and *Bankruptcy and Insolvency Act* that make directors liable for authorizing certain corporate actions. For example, they are liable for: (1) the making of payment of a dividend or the redemption, purchase or acquisition of shares by the corporation, or the making of a payment to a shareholder, where the directors have reasonable grounds to believe that after making the payment the corporation would be unable to pay its liabilities or that the realizable value of the corporation’s assets would be less than the aggregate of its liabilities and stated capital; (2) the issuance of shares of the corporation for inadequate consideration; (3) the providing of financial assistance to any person without making the appropriate disclosure to the shareholders of the corporation; or (4) the making of a payment of an indemnity to an officer or director in violation of the other statutory provisions. It will be difficult for the directors to defend themselves against actions in the above situations if they have not objected to making such payments, even if in reaching their decisions they relied on the information provided by the corporation’s accountants, auditors, appraisers or solicitors.

The liability of directors to the employees of the corporation lies for the debts that a corporation owes to the employees for up to 6 months’ wages for services performed and

for accrued vacation pay for up to 12 months. Although the directors' liability for wages and vacation pay is not automatic, if certain conditions are met, including a suit being commenced against a director within a certain time period, the directors' liability becomes absolute. Although a director may avoid liability for vacation pay if he or she resigns his or her position before the termination of the aggrieved employee's employment, the director cannot avoid liability for unpaid wages by doing so if he or she was a director at the time the wages were not paid and if the suit was commenced by the employee within the statutory period.

The liability of directors to third parties (mostly governmental entities) exists under dozens of federal and provincial statutes, for example, for defaults in making required payments or reporting or for violating labour or environmental laws. The most notable types of liability in the first two categories are for defaults by the corporation in the collection and remittance of income taxes withheld from employee's wages, GST, retail sales tax, employment insurance premiums and Canada Pension Plan contributions. In such cases, the statutes impose joint and several liability on the directors (meaning that the government may seek recourse against all of them together or against each director individually) treating them as personal financial guarantors that the statutory obligations of the corporation will be fulfilled and the required payments made.

How can directors protect themselves from liability? First, a person should not agree to become a director unless the corporation agrees in writing to indemnify the director from certain liabilities and claims if the director has acted honestly. Second, one should rarely agree to become a director unless the corporation carries sufficient insurance to protect directors from liability or costs of lawsuits. Most importantly, however, a director who is not otherwise running the day-to-day operations of the corporation must find the time to not only periodically check its financial documents, but also to discuss with the accountants, auditors or solicitors of the corporation (and keep notes of such discussions) the financial and legal condition of the corporation. By doing so, the director is likely to at least meet the minimum threshold of "due diligence" required to defend possible legal actions in the future. Finally, the director should periodically visit the corporate premises and engage in discussions with regular employees to make sure that there are no signs of financial or employment standards irregularities that are not reflected in the written reports that arrive at the director's desk a few hours before the meeting of the board of directors.