Potential Liabilities for Directors in Insolvency: Considerations for Directors of Companies Facing COVID-19 Induced Insolvency

The global pandemic of the disease caused by a novel coronavirus, COVID-19, has caused unprecedented disruption to global supply chains and consumer demand and resulted in government-mandated restrictions to almost all businesses. Many companies, small and large, are facing insolvency and forced to make rapid decisions about what steps that they should take.

Directors of companies have certain obligations under both common law and the laws of Canada and the provinces. In addition are specific obligations and liabilities that arise when a company is insolvent or close to insolvency. This is intended as a general overview of such obligations under Canadian law and the laws of British Columbia and Alberta and does not constitute legal advice. Contact Lawson Lundell's Insolvency and Restructuring Group for specific advice.

DIRECTORS' DUTIES

There are four important concepts related to director liability:

1. The "fiduciary duty" directors owe to the company;
2. The "duty of care" that directors must exercise;
3. The statutory duty of directors to disclose information under corporate statutes; and
4. Common liabilities imposed on directors through other statutes, both federal and provincial.

Most Canadian corporate statutes have a similar prescribed duty of directors and officers, along the following lines[1]:

> "A director or officer of a company, when exercising the powers and functions of a director or officer of the company, as the case may be, must:
>
> (a) act honestly and in good faith with a view to the best interests of the company; and
>
> (b) exercise the care, diligence and skill that a reasonably prudent individual would exercise in comparable circumstances.

The duties described in (a) are commonly referred to as the common law fiduciary duties of directors, while (b) is often equated with the common law duty of care.

[1] In BC, this is found at section 142(1) of the BC *Business Corporations Act*, in Alberta at section 122(1) of the Alberta *Business Corporations Act*, in the NWT at s. 123(1) of the Northwest Territories *Business Corporations Act*, and in Nunavut at s. 123(1) of the Nunavut *Business Corporations Act*.

1. The "Fiduciary Duty"

The Supreme Court of Canada has set out specific rules for directors to follow in order to fulfill their fiduciary duty.[2] The fiduciary duty requires directors and officers to act honestly and in good faith in all dealings with the company. Directors must respect the trust and confidence that has been placed in them to manage the assets of the corporation in a manner consistent with the objects of the company. The Supreme Court of Canada set out the following principles related to the fiduciary duty of directors:

(a) directors must avoid conflicts of interest with the corporation;

(b) directors must avoid abusing their position to gain personal benefit;

(c) directors must maintain the confidentiality of information they acquire by virtue of their position; and

(d) directors must serve the company selflessly, honestly and loyally.

There are a number of circumstances in which a director can breach his or her fiduciary duties, but the overarching principle is that the directors must always *act honestly and in good faith with a view to the best interests of the company*.

The presence of the fiduciary duty does not mean that the directors must avoid all personal gain as a direct or indirect result of their involvement with the company. The fiduciary duty is only concerned with actions that may be in conflict with the interests of the company.

The fiduciary duty is only owed to the company. Although it is true that directors owe their fiduciary duties to the company and not to any other stakeholder, the practical reality is that in most situations, the "best interest of the corporation" will typically involve the "best interest of the shareholder".

Most provincial/territorial corporate statutes have similar sections setting out the fiduciary duty.[3]

2. The "Duty of Care"

As noted above, the common law "duty of care", which is generally incorporated into provincial corporate statutes, is to exercise the care, diligence and skill that a reasonably prudent individual would exercise in comparable circumstances.

This duty creates an objective standard to measure the director's care, diligence and skill against. The fiduciary duty involves the subjective motivation of the director, while the duty of care deals with the objective factual aspects of the circumstances surrounding the actions of the director.

[2] *Peoples Department Stores Inc. (Trustee of) v. Wise*, 2004 SCC 68

[3] BC: section 142(1)(a) of the BC *Business Corporations Act*; Alberta: section 122(1)(a) of the Alberta *Business Corporations Act*; Northwest Territories: section 123(1)(a) of the *NWT Business Corporations Act*; and Nunavut: section 123(1)(a) of the Nunavut *Business Corporations Act*.

Whether or not a director has breached the "duty of care" often comes down to an analysis of whether the business decisions made by the director were reasonable in light of all of the circumstances. Courts in Canada follow the "business judgment rule", which states that courts will not in hindsight second-guess business decisions which were reasonable and defensible at the time they were made, although they ended up being ultimately unsuccessful. In determining whether directors have acted in a manner that breached the duty of care, perfection is not demanded. There will be no breach of the duty of care as long as the directors can show that they acted prudently and on a reasonably informed basis.

Traditionally, the duty of care has only been owed to the shareholders of the company. However, the wording of these statutes leaves open the possibility that *a duty of care may also be owed to other stakeholders, including creditors.*

Whether or not the duty of care can be extended to parties other than the shareholders in the common law jurisdictions has not yet been addressed by the courts, however, it has now become generally accepted that directors do owe a duty of care to creditors of a corporation when "near insolvency". This duty is generally met by dealing with creditors in the manner addressed below.

Most provincial/territorial corporate statutes have similar sections setting out the duty of care.[4]

3. <u>The Statutory Duty to Disclose Information</u>

Technically, the duty to disclose information is an extension of the director's fiduciary duty. As mentioned earlier, the fiduciary duty prohibits the directors from engaging in any action which could potentially result in a conflict of interest. If there is any conflict, generally corporate statutes require the director to disclose those interests in a timely fashion.

Generally, there are two separate streams for director disclosure, first where the director holds any office or property that gives rise to a conflict of interest, or, secondly, where the director has any sort of personal financial interest in a transaction. The courts will look at whether there is a "disclosable interest" in a transaction, which is one in which the director has a "material interest".

A "disclosable interest" in a transaction generally arises where:

(a) the contract or transaction is material to the company;

(b) the company has entered, or proposes to enter, into the contract or transaction, and

(c) either of the following applies to the director or senior officer:

  (i) the director or senior office has a material interest in the contact or transaction;

[4] BC: section 142(1)(b) of the BC *Business Corporations Act*; Alberta: section 122(1)(b) of the Alberta *Business Corporations Act*; Northwest Territories: section 123(1)(b) of the NWT *Business Corporations Act*; and Nunavut: section 123(1)(b) of the Nunavut *Business Corporations Act*.

(ii) the director or senior officer is a director or senior officer of, or has a material interest in, a person who has a material interest in the contract or transaction.

A "material interest" can include personal relationships that a director has a with a party to a material contract. For example, if the transaction involves a personal friend of the director, then that would constitute a "material interest" even if the director did not possess any financial interest in the transaction.

If a contract or transaction where a director has a "disclosable interest" is approved without the director disclosing that interest, the court may do any or all of the following: order that the contract/transaction be set aside, require the director to pay back to the corporation any profit received as a result of the contract transaction, or make any other order that the court considers appropriate.

4. <u>Statutory Liabilities of Directors</u>

This post only addresses director liability arising from insolvency and does not purport to address other non-insolvency liabilities, other than to the extent they commonly arise.

The majority of areas of potential liability arise from unpaid employee wage claims and the failure to remit taxes collected on behalf of Her Majesty.

<u>Specific Statutory Sources of Liability</u>

i. *Bankruptcy and Insolvency Act Liability*

The *Bankruptcy and Insolvency Act*, Canada's main insolvency law, imposes a number of liabilities on directors of insolvent companies.

A director can be personally liable if he or she:

- fails to comply with the obligations imposed on a bankrupt under the *Bankruptcy and Insolvency Act*.
- is a director of a company that commits an offence under the *Bankruptcy and Insolvency Act* (e.g. wrongfully disposes of property).

ii. *Liability for unremitted taxes*

A particular concern for directors of insolvent companies are personal liabilities for unremitted taxes owed under the *Excise Tax Act* and the *Income Tax Act*.

Directors can be personally liable:

- Under the *Excise Tax Act*, failing to remit net tax. Directors can be liable to pay the amount that was not remitted, plus any interest or penalties related to the amount; and

- Under the *Income Tax Act*, failing to deduct or withhold requirements amounts, including unpaid source withholdings of employee payroll deductions. Directors can be personally liable to pay the amount that is required to be deducted or withheld and any interest or penalties related to that amount.

Taxation legislation (including provincial Sales Tax acts) also provide that a director of a company is guilty for an offence if he or she directs, authorizes, assents, acquiesces to or participates in the commission of an offence under that Act. A director is liable personally for the punishment provided for that offence, including a fine usually based on the amount of unremitted taxes.

iii. *Liability for unpaid wages*

Directors can also be personally liable for unpaid wages of employees, as follows:

- Federally: Under the *Wage Earners Protection Act*, for payments paid out of the Consolidated Revenue Fund in respect of an employee's unpaid wages.

- BC: The *Employment Standards Act* makes a director personally liable for unpaid wages earned by employees during a period of up to 2 months prior to bankruptcy.

- Alberta: Directors face liability under the *Business Corporations Act* and the *Employment Standards Code* for up to 6 months of unpaid wages earned by employees prior to bankruptcy, unless a claim for those wages is proven in the bankruptcy.

- NWT: Directors are liable for unpaid wages to employees for:
  - up to 6 months of unpaid wages, unless a claim for those wags is proven in the bankruptcy, under the *Business Corporations Act*; and
  - up to 2 months' wages for each employee who not been paid, under the *Employment Standards Act*

- Nunavut: Directors are liable for unpaid wages to employees for:
  - up to 6 months of unpaid wages, unless a claim for those wags is proven in the bankruptcy, under the *Business Corporations Act*; and
  - up to 2 months' wages for each employee who not been paid, under the *Labour Standards Act*

iv. Liability for payments while company insolvent

A director can be personally liable if he or she authorizes commissions, dividends, share purchases or redemptions, payments or indemnities when the company is insolvent or to take such an act would make the company insolvent, or within a 12 months of an act of insolvency or a winding up. A director who authorizes such an act is liable to compensate the company or shareholder for the losses sustained as a result of that act. (see e.g. BC *Business Corporations Act, Winding up and Restructuring Act, and Bankruptcy and Insolvency Act*).

v. Liability for Environmental Damage

A director can be held personally liable for environmental offences under the relevant provincial/territorial statutes, if he or she directed, authorized, assented to, acquiesced or participated in the offences.

Considerations for Managing Debt

Under the Canadian *Bankruptcy and Insolvency Act*, and provincial legislation, once a company is insolvent, all creditors are to be treated fairly and equitably, according to their priority.

In other words, creditors with validly perfected security are to be paid according to their priority, with all other unsecured and trade creditors being treated on a general pro rata basis, regardless of whether or not the company and/or the directors have a risk of potential liability for those debts.

The general rule is that only "ordinary course payments", as would normally be made if not insolvent, ought to be made to unsecured creditors. If you are unable to make all of your "ordinary course" payments, then unsecured creditors should be treated equitably and fairly, which generally means on a pro rata basis.

Under Canadian bankruptcy law, however, equitably and fairly does not always mean "equally". Specifically, concessions can be made for:

(a) obligations that would otherwise be given preferences under the *Bankruptcy and Insolvency Act*, with potential for deemed trusts over the assets of the company, including under the *Wage Earner Protection Act*; and

(b) "critical suppliers", i.e. those that are vital and necessary to the continued operations of the undertaking.

However, care must be taken with respect to debts under these categories as there is grey area as to whether or not such payments will be upheld.

Any transaction that has the effect of preferring, defeating, delaying or hindering creditors of their just remedies may be considered fraudulent, and will give rise to a cause of action to have such transaction voided and/or set aside.

In particular, outside of a formal insolvency proceeding, other creditors will have claims if the transaction are either a "fraudulent preference" (preferring one creditor over another, with the intent to "defeat, delay or hinder" that creditor) or a "fraudulent conveyance" (a conveyance of property, broadly defined, that is made to "defeat, delay or hinder" any creditor of its remedies).

Where a formal insolvency proceeding is commenced, any transaction that has any of these effects within prescribed periods (generally one year for arm's length transactions, and three years for non-arm's length, prior to initial bankruptcy event) are reviewable transaction which are deemed to be improper, shifting the burden of proof on the debtor to prove that they were fair market value and reasonable transactions.

Emergency Financing

In addition, if a company takes on new debt to address a liquidity crisis, care must be taken to ensure that that the overall indebtedness is not being increased and/or the current creditors unduly prejudiced.

However, it should also be noted that the various options for reorganizing debt under Canada's insolvency regimes do allow for what is referred to as "Debtor in Possession" ("DIP") financing, whereby a DIP lender can get "super-priority" security for cash flow needs during a reorganization, to "keep the lights on" and pay necessary obligations during that period.

The above is an overview only, and we would recommend that before any active steps are taken, that the above points are discussed with us with specific reference to the issues relevant to your company.

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