

IS THERE A MEANINGFUL DIRECTORS' DUE DILIGENCE DEFENCE FOR UNPAID TAXES?

What can a director or officer do to avoid personal liability to the Canada Revenue Agency (“CRA”) for unremitted taxes when the corporate ship is sinking under financial pressures?

In the recent case of *Regina v. Buckingham*, 2011 FCA 142 (“*Buckingham*”), the Federal Court of Appeal seems to be suggesting that the answer is “not much”.

The director in *Buckingham* took all reasonable measures to keep his financially distressed company afloat, including attempting to secure new financing (both debt and equity), reducing expenditures, attempting to merge with a strategic partner and, when all else failed, entering into an agreement for the sale of an operating division with the objective of paying off CRA and other creditors from the proceeds of sale: indeed, a payment on account of some of the outstanding source deductions was made to CRA as a result. Notwithstanding those efforts the Federal Court of Appeal, reversing the Trial Division, held the director personally liable for unremitted source deductions and GST payments. The case suggests that the director personally would have been better off had he not tried to keep the company operating during difficult financial times, because by taking that course he had to maintain the employment of and pay wages to employees.

Buckingham deals with the sections of the *Income Tax Act* and the *Excise Sales Tax Act* which impose personal liability on officers and directors for unremitted employee source deductions and GST amounts, respectively. Those sections allow for a defence of due diligence, and it was the due diligence of Mr. Buckingham which was in issue. The specific formulation of the due diligence defence under the taxing statutes is that a director is exonerated from liability where he or she “exercised the degree of care, diligence and skill to *prevent the failure* that a reasonably prudent person would have exercised in comparable circumstances”. The italicised words refer to preventing the failure to remit.

Importantly, the Federal Court of Appeal in *Buckingham* found that the general duties of care that we associate with directors as codified in the corporate statutes are not applicable to the due diligence defence under the taxing statutes. The Court held that the general directors’ duty to exercise the care, diligence and skill of a reasonably prudent person in comparable circumstances does not relate to any identifiable party as the beneficiary of the duty. By contrast, the provisions of the taxing statutes do not establish a general duty of care but rather provide a defence to the personal liability provisions. The specific target is the prevention of a company’s failure to remit and arguably this duty is owed to CRA.

In focussing on the purpose of the taxing statutes – which is to prevent failures to remit – the Court held that the director’s conduct must be assessed as of the time it becomes apparent to the director that the corporation is entering a period of financial difficulties, before any failures to remit have occurred.

While the Trial Division found that the director had made reasonable efforts and hence permitted Mr. Buckingham to shelter under the due diligence defence, the Court of Appeal disagreed. It held that “a director of a corporation cannot justify a “due diligence” defence under the *Income*

Tax Act where he condoned the continued operation of the corporation by diverting employee source deductions to other purposes. Although the respondent had a reasonable (but erroneous) expectation that the sale of the division of the company could result in a large payment which could be used to satisfy creditors, he consciously transferred part of the risks associated with this transaction to the Crown by continuing operations knowing that employee source deductions would not be remitted”.

In the result the director was denied the due diligence defence and held liable for the unremitted deductions.

The interesting (but unexamined) implication of this case is the conflict between the director’s self-interest (i.e. to avoid personal liability to CRA) and his or her obligation to advance the best interests of the company and its relevant stakeholders. As the director *Buckingham* no doubt thought, his efforts were directed to the latter duty. Had he succeeded all corporate stakeholders (including CRA) would have benefited. Having failed, the director personally paid the price.

While the Court of Appeal stressed that a director’s efforts to keep the financially distressed company alive must not treat CRA as an involuntary creditor by using the unremitted deductions to pay other creditors, it will often simply not be possible to both keep operating and to maintain the remittances. In that situation, *Buckingham* suggests that it will be extremely difficult to establish a due diligence defence once the remittances have not been made.

Helen Daley is a partner at Wardle Daley Bernstein LLP, a commercial litigation firm in Toronto, and has acted in numerous commercial list cases.