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The Supreme Court's Decision in Peoples: A New Standard of Directors' Liability?

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PRÉCIS

La norme de soin, diligence et habileté requise d'une administrateur de société pour contester les demandes par l'Agence du revenu du Canada de retenues d'impôt et de taxe sur les produits et services (TPS) non remises a été décrite comme une norme « objective subjective ». Dans un récent jugement, la Cour suprême du Canada a provoqué un changement dans la défense de diligence raisonnable en privilégiant l'application de la norme objective seulement. Ce sont non seulement les considérations de fait de causes futures qui seront vues dans une perspective différente, mais également les avis donnés à certains administrateurs de sociétés. Cela est particulièrement évident dans le cas où un membre de la famille doit être nommé administrateur passif ou nominal.

ABSTRACT

The standard of skill, care, and diligence required of a director of a corporation to defend claims by the Canada Revenue Agency for source deductions or goods and services tax (GST) not remitted has been described as "objective-subjective." A recent Supreme Court of Canada decision has mandated a course of change for the due diligence defence by preferring application of only the objective standard. Not only will factual considerations of future cases be viewed in a different light, but so will advice given to certain corporate directors. This is particularly apparent in circumstances when a family member is to be appointed as a nominal or passive director.

KEYWORDS: DIRECTORS' LIABILITY ■ DEDUCTIONS ■ GST

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INTRODUCTION

In the autumn of 2004, the Supreme Court of Canada in *Peoples Department Stores Inc. (Trustee of) v. Wise*[1] held that the directors of a corporation did not owe a fiduciary duty of honesty and good faith to the creditors of the corporation even when it was in the vicinity of insolvency. Because there had been no fraud or dishonesty motivating the directors' actions, their statutory duty[2] to act in good faith in the best interests of the corporation had not been breached in the circumstances. There has been much academic commentary relating to this decision.[3]

On the other hand, the Supreme Court did conclude that the directors of a corporation owed a statutory duty of care, diligence, and skill to its creditors.[4] It found that, in the circumstances of the case, this duty had not been breached because the action taken by the directors was pursuant to a reasonable business decision made with a view to rectifying a serious and urgent business problem.[5] There has been academic commentary relating to this part of the decision as well.[6]

Wise Stores Inc. ("Wise") acquired Peoples Department Stores Inc. ("Peoples") from Marks and Spencer Canada Inc. ("M & S"). Wise was controlled by three brothers who were its officers and directors and who also became the only directors of Peoples. The cost of the share acquisition was a fully leveraged buyout, and to protect its interests, M & S negotiated strict covenants concerning the financial management and operation of Peoples. Further, Peoples and Wise could not be merged

1 [2004] 3 SCR 461.

2 Canada Business Corporations Act, RSC 1985, c. C-44, as amended, section 122(1)(a).

3 Catherine Francis, "Peoples Department Stores Inc. v. Wise: The Expanded Scope of Directors' and Officers' Fiduciary Duties and Duties of Care" (2005) vol. 41, nos. 2-3 *Canadian Business Law Journal* 175-83; Wayne D. Gray, "A Solicitor's Perspective on Peoples v. Wise" (2005) vol. 41, nos. 2-3 *Canadian Business Law Journal* 184-99; Warren Grover, "The Tangled Web of the Wise Case" (2005) vol. 41, nos. 2-3 *Canadian Business Law Journal* 200-11; Ian B. Lee, "Peoples Department Store v. Wise and the 'Best Interests of the Corporation'" (2005) vol. 41, nos. 2-3 *Canadian Business Law Journal* 212-22; Jacob S. Ziegel, "The Peoples Judgment and the Supreme Court's Role in Private Law Cases" (2005) vol. 41, nos. 2-3 *Canadian Business Law Journal* 236-46; Darcy L. MacPherson, "The Supreme Court Restates Directors' Fiduciary Duty—A Comment on Peoples Department Stores v. Wise" (2005) vol. 43, no. 2 *Alberta Law Review* 383-406; Anita Anand and Jessica Penley, review of Joel Bakan, *The Corporation: The Pathological Pursuit of Profit and Power* (2005) vol. 30, no. 2 *Queen's Law Journal* 938-52; and Mohamed F. Khimji, "Peoples v. Wise—Conflating Directors' Duties, Oppression, and Stakeholder Protection" (2006) vol. 39, no. 1 *UBC Law Review* 209-32.

4 Supra note 1, at paragraph 57.

5 Ibid., at paragraph 71.

6 Gray, supra note 2; Ziegel, ibid.; Stéphane Rousseau, "Directors' Duty of Care After Peoples: Would It Be Wise To Start Worrying About Liability?" (2005) vol. 41, nos. 2-3 *Canadian Business Law Journal* 223-35; James Dube, "Directors' Duties to Creditors" (2005) vol. 22 *National Insolvency Review* 29-33; and Jeffrey C. Carhart, "The Duties and Responsibilities of Corporate Directors in Canada—An Update" (2005) vol. 18, no. 2 *Commercial Insolvency Reporter* 29-32.

until the purchase price had been fully paid. From the outset, the joint operation of Wise and Peoples did not function smoothly. Parallel bookkeeping and shared warehouse arrangements caused serious inventory problems.

An executive of both Wise and Peoples recommended the implementation of a joint inventory procurement policy whereby the two corporations would divide responsibility for purchasing. Peoples would make all purchases from North American suppliers, and Wise would make all purchases from overseas suppliers. Each corporation would then transfer to the other what it had purchased on the other's behalf. Because most of the inventory was purchased from North American suppliers, Peoples was extending significant trade credit to Wise. At the time, the competition in the retail market in eastern Canada was fierce, particularly with the entry of Wal-Mart into the Canadian market. Financial results of both Wise and Peoples worsened, resulting in M & S initiating bankruptcy proceedings against both corporations.

The trustee in bankruptcy filed a petition against the three Wise brothers and claimed that they had breached their fiduciary duties in these circumstances by favouring the interests of Wise over Peoples to the detriment of Peoples' creditors. The Supreme Court ultimately rejected this claim.

In discussing the standard of care embodied in section 122(1)(b) of the Canada Business Corporations Act,[7] the Supreme Court referred to the Federal Court of Appeal decision in *Soper v. The Queen*.[8] That decision was the first to set out a comprehensive analysis of the standard of care, diligence, and skill required under subsection 227.1(3) of the Income Tax Act,[9] and it has provided the analytical foundation for many cases decided by the Tax Court of Canada since 1998. The *Soper* decision served as a relevant comparison in *Peoples* because the language establishing the standard of care is virtually identical in the two statutes. In *Soper*, the Federal Court of Appeal had held that the standard of care was "objective subjective." The Supreme Court, with respect, was of the opinion that this standard could lead to confusion and preferred the "objective" standard.

In the Supreme Court's opinion, the objective standard made clear the importance of the factual aspects of the circumstances surrounding the actions of directors. These considerations were distinguishable from any factors forming the subjective motivation that was central to the duty of good faith and loyalty. This reformulated "contextual approach" not only emphasized the primary facts but also permitted prevailing socioeconomic conditions to be taken into account.[10] The emergence of

7 Supra note 2. Section 122(1)(b) states, "Every director and officer of a corporation in exercising their powers and discharging their duties shall . . . exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."

8 97 DTC 5407 (FCA).

9 RSC 1985, c. 1 (5th Supp.), as amended. Unless otherwise stated, statutory references in this article are to the Income Tax Act.

10 Supra note 1, at paragraph 64.

this stricter standard was in line with the establishment of good governance rules and would put pressure on corporations to improve the quality of board decisions.[11]

For tax practitioners, *Peoples* has changed the statutory standard of care and raised the level of diligence to be exercised. How will this affect the advice to be given? In circumstances where the objective standard is already applied, no change in current advice will be needed. However, caution should be exercised whenever a nominal or passive director is to be appointed, particularly if the appointee is a family member or friend of the controlling shareholder and if there is no expectation that he or she will be involved in the affairs of the corporation. As will be discussed later, in such circumstances the tax practitioner should alert the client to the new potential liability or insist that the appointee obtain independent legal advice.

The purpose of this article is to examine the impact of this change in the standard of care in cases that employ the due diligence defence under subsection 227.1(3) of the Income Tax Act and subsection 323(1) of the Excise Tax Act.[12] Subsection 227.1(3) states:

> A director is not liable for a failure under subsection (1) where the director exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.[13]

As noted above, this language is virtually identical to that used in the standard of care provision in the Canada Business Corporations Act. There has been considerable commentary relating to the breadth and scope of subsection 227.1(3).[14]

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11 Ibid.

12 Excise Tax Act, RSC 1985, c. E-15, as amended. Several other statutes provide an identical defence in respect of liability for contributions, premiums, or withholdings not remitted: see the Canada Pension Plan, RSC 1985, c. C-8, as amended, section 21.1; the Employment Insurance Act, SC 1996, c. 23, as amended; and the Ontario Income Tax Act, RSO 1990, c. I.2, as amended, section 38.

13 Subsection 227.1(1) states, "Where a corporation has failed to deduct or withhold an amount as required by subsection 135(3) or 135.1(7) or section 153 or 215, has failed to remit such an amount or has failed to pay an amount of tax for a taxation year as required under Part VII or VIII, the directors of the corporation at the time the corporation was required to deduct, withhold, remit or pay the amount are jointly and severally, or solidarily, liable, together with the corporation, to pay that amount and any interest or penalties relating to it."

14 Edwin G. Kroft, "The Liability of Directors for Unpaid Canadian Taxes," in *Report of Proceedings of the Thirty-Seventh Tax Conference*, 1985 Conference Report (Toronto: Canadian Tax Foundation, 1986), 30:1-90; R. Lynn Campbell, "The Fiduciary Duties of Corporate Directors: Exploring New Avenues" (1988) vol. 36, no. 4 *Canadian Tax Journal* 912-23; Evelyn P. Moskowitz, "Directors' Liability Under Income Tax Legislation and Other Related Statutes" (1990) vol. 38, no. 3 *Canadian Tax Journal* 527-85; R. Lynn Campbell, "Directors' Liability for Unremitted Employee Deductions" (1993) vol. 14, no. 4 *The Advocates' Quarterly* 453-81; Michael Balter, "Director's Liability and Due Diligence—A Step in the Right Direction" (1995) vol. 5, no. 7 *Canadian Current Tax* 69-72; E.G. Kroft, "The Due Diligence Defence Under Section 227.1: Who Is Right—Revenue Canada or the Federal Court of Appeal?" Current

The discussion that follows considers the impact of the *Soper* and *Peoples* decisions on existing subsequent jurisprudence, and explores possible changes in case analysis by the Tax Court of Canada in respect of subsection 227.1(3).

THE IMPACT OF SOPER

Even though the Tax Court of Canada felt, at first, that it was not necessary to articulate the standard of care required under subsection 227.1(3), it soon became necessary to affirm that directors had an obligation to take positive action to prevent any default in remittances.[15] This obligation flowed from the diligence requirement in subsection 227.1(3). Inattention to the obligation to remit source deductions was not acceptable. Reliance on a person capable of making remittances, or the lack of a system to deal with them effectively, was not sufficient for a successful defence.[16] In other words, doing nothing was not an option.

Early applications of the due diligence requirement related to prudence rather than care; however, the degree of prudence required was not excessive. Having a tried and tested system in place to make remittances would be sufficient; or an unexpected default owing to bank intervention would be excusable.[17] Also, the "circumstances" allowed the court to take into account a director's personal attributes, such as education, ability, business knowledge, and experience.[18] Thus, for a director with limited knowledge and experience, the degree of diligence would be at the low end, and for a director with superior training and experience, it would be at the high end.

In other cases, the standard of care required under subsection 227.1(3) was considered to be of a relatively high order, and the "circumstances" related to operational and administrative aspects of the corporation rather than the personal attributes or characteristics of the director.[19] Therefore, age, health, or limited financial resources

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Cases feature (1997) vol. 45, no. 3 *Canadian Tax Journal* 549-55; Werner Heinrich, "An Update on Directors' Liability," in *2000 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2000), tab 1, at 25-32; and Martha O'Brien, "The Director's Duty of Care in Tax and Corporate Law" (2003) vol. 36, no. 3 *UBC Law Review* 673-91. For a complete compilation and cataloguing of all reported cases under subsection 227.1(1) of the Income Tax Act and subsection 323(1) of the Excise Tax Act from 1985 to 2006, see R. Lynn Campbell, *Director's Liability Casebook* (Ottawa: Canada Revenue Agency, 2006), 465.

15 *Fraser v. MNR*, 87 DTC 250 (TCC); *Edmondson v. MNR*, 88 DTC 1542 (TCC); *Quantz v. MNR*, 88 DTC 1201 (TCC); and *Nice v. MNR*, 91 DTC 628 (TCC).

16 *Barnett v. MNR*, 85 DTC 619 (TCC); *Wilson v. MNR* (1988) [unreported]; *Friss v. MNR*, 91 DTC 702 (TCC); and *Seymour v. The Queen*, [1995] 2 CTC 2446(D) (TCC).

17 *Merson v. MNR*, 89 DTC 22 (TCC).

18 *Robitaille v. The Queen*, 90 DTC 6059 (FCTD); *Sheremeta v. MNR*, 91 DTC 867 (TCC); *Noonan et al. v. MNR*, 91 DTC 416 (TCC); *MacCormack v. MNR*, [1995] 2 CTC 2410(D) (TCC); *Gregory v. The Queen* (1996), 4 GTC 3137 (TCC); and *Davies-Edwards v. The Queen*, 97 DTC 373 (TCC).

19 *White v. MNR*, 91 DTC 54 (TCC); and *Sandford v. The Queen*, 96 DTC 1912 (TCC).

were not factors for consideration.[20] Further, the standard required a reasonably prudent person to attempt to discover what was required of him.[21] Thus, a deliberately passive director who took no role in management did not meet the required standard of care.[22]

Apart from this patchwork of decisions, in the pre-*Soper* period, the underlying question of the standard of care, diligence, and skill to be exercised by a director in the performance of his or her duties was largely ignored. Because of the availability of other defences, many directors' liability cases decided in the Tax Court were disposed of without reference to the due diligence requirement. For example, directors who decided not to remit source deductions, applying them instead to the payment of key creditors whose goods or services were essential to the continued operation of the business, might rely on any of several alternative arguments.[23] Thus, the patent abuse and mismanagement on the part of directors that constituted the "mischief" at which subsection 227.1(1) was directed were dealt with, for the most part, without reference to any standard of care applicable to the conduct in question.[24] The gap left by the lack of an articulated standard was bridged by the principles of common sense and fairness applied by judges of the Tax Court.

At the Federal Court of Appeal in *Soper*, Robertson JA was of the opinion that the court's mandate was to consider and reconcile the Tax Court's allegedly inconsistent jurisprudence.[25] The requisite degree of care, diligence, and skill determined as a "question of fact" was an oversimplification. To establish the requisite statutory standard, it was essential to determine whether the personal knowledge and background of a director was a relevant consideration or whether the standard was an entirely objective one applicable to all directors. The majority of the judges in the Tax Court had adopted the subjective standard, but some had rejected it in favour of the objective standard. Robertson JA concluded that the federal legislation included an objective component, but he largely adopted the common-law position to the extent that any legislative changes recognized the subjective element.[26]

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20 *White*, supra note 19, at 60. See also *Fedson v. The Queen*, 96 DTC 3204(S) (TCC).

21 *Black v. The Queen*, 93 DTC 1212 (TCC).

22 *Quantz*, supra note 15; *Scaletta v. The Queen*, 94 DTC 1465 (TCC); and *Cadrin v. The Queen*, 97 DTC 995 (TCC).

23 The appellant might have argued director status (that he was not a director, had no de jure or de facto status, or was a passive director), limitations on liability (non-compliance with a condition precedent or ceasing to be a director two years before assessment), or an incomplete and invalid notice of assessment. Very few cases were heard during the period between the trial decision in *Leung v. MNR*, 91 DTC 1020 (TCC) (assessment set aside because it was incomplete) and its appeal, 93 DTC 5467 (FCTD) (which was allowed).

24 For early discussion, see Kroft, "The Liability of Directors for Unpaid Canadian Taxes," supra note 14, and Moskowitz, ibid.

25 Supra note 8, at 5408.

26 Ibid., at 5409.

To this end, the Court of Appeal reviewed the legislative history and framework of the standard of care as it applied to corporation law in general and, specifically, to the Income Tax Act. With respect to the latter, subsection 227.1(1) was enacted to facilitate the revenue department's collection process by broadening the exposure of directors to personal liability. The harshness of this provision, which initially provided for absolute liability, was tempered by the introduction of the due diligence defence in subsection 227.1(3). The Court of Appeal noted that the common-law duty of care for directors started with an analysis of *In Re City Equitable Fire Insurance Co.*,[27] which adopted the subjective standard. Attempts to either modify or upgrade the common-law subjective standard by statute were reviewed. However, few minimum qualifications were required of directors who had to exercise business judgment that entailed some degree of risk taking. This made the articulation of any minimum standard of competence applicable to all directors very difficult. Robertson JA courageously attempted an upgraded articulation of the standard:

> This is a convenient place to summarize my findings in respect of subsection 227.1(3) of the *Income Tax Act*. The standard of care laid down in subsection 227.1(3) of the Act is inherently flexible. Rather than treating directors as a homogeneous group of professionals whose conduct is governed by a single, unchanging standard, that provision embraces a subjective element which takes into account the personal knowledge and background of the director, as well as his or her corporate circumstances in the form of, *inter alia*, the company's organization, resources, customs and conduct. Thus, for example, more is expected of individuals with superior qualifications (e.g., experienced business-persons).
>
> The standard of care set out in subsection 227.1(3) of the Act is, therefore, not purely objective. Nor is it purely subjective. It is not enough for a director to say he or she did his or her best, for that is an invocation of the purely subjective standard. Equally clear is that honesty is not enough. However, the standard is not a professional one. Nor is it the negligence law standard that governs these cases. Rather, the Act contains both objective elements—embodied in the reasonable person language—and subjective elements—inherent in individual considerations like "skill" and the idea of "comparable circumstances." Accordingly, the standard can be properly described as "objective subjective."[28]

In addition to articulating the standard applicable to a subsection 227.1(3) defence, the Court of Appeal adopted an analytical approach by classifying directors as either "inside" or "outside." Liability would not be dependent upon such a classification, but this characterization would be the starting point of the analysis. Inside directors—those who were involved in day-to-day management and who influenced the conduct of business affairs—would have the most difficulty in establishing the defence.

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27 [1925] 1 Ch. 407 (CA).

28 Supra note 8, at 5416. The Quebec Court of Appeal in *Peoples Department Stores Inc. (Trustee of) v. Wise* (2003), 224 DLR (4th) 509, at paragraph 78, adopted and quoted this language as an accurate definition of "the contours of the concept of standard of care."

It would be difficult for them to argue convincingly that the subjective element of the standard should predominate over its objective aspect.[29] Specifically, it would be a challenge for them to argue that they did not know, or that they could not be expected to have known, of the remittance requirements or an actual default.

On the other hand, it would be easier for outside directors—those who were not involved in day-to-day management or were not influential in the conduct of the business—to argue that they lacked the business acumen or knowledge of a default in remittances. These directors could, in the absence of grounds for suspicion, rely upon the day-to-day corporate managers to be responsible for making remittances. However, outside directors would not be able to adopt a passive approach. As soon as they became aware of a potential problem with remittances, they would have a positive duty to act.[30] It would be a question of fact for the Tax Court to determine on the basis of financial documentation available to the directors whether they knew or ought to have known whether there had been a problem with remittances.

THE POST-SOPER EXPERIENCE

Soper became the template for many subsequent cases in the Tax Court of Canada. Since 1998, it has been cited or applied in approximately 90 cases.[31] The inquiry to determine the standard of care commenced with the methodology of classification. The Tax Court examined the role and function expected of and performed by individual directors. It also examined financial statements and events that related to the corporation's financial health, to determine whether there were grounds for suspicion. The personal attributes of education, competence, and experience of individual directors were now legitimate considerations in establishing the level of care required.

Once an individual was designated as an outside director, it was easier for the Tax Court to apply a lower standard of care. An outside director could rely on a competent co-director or manager involved in the day-to-day management of the business to remit source deductions. Positive action to prevent defaults would not always be required.[32] However, even the lower statutory standard of care encouraged responsibility, and passivity based on total ignorance was no excuse.[33] Once suspicion had been aroused as to the corporation's ability to pay its liabilities, the standard of care

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29 Supra note 8, at 5417.

30 Ibid., at 5418.

31 To be exact, 89 at the time of writing.

32 *Boyd et al. v. The Queen*, 99 GTC 3074 (TCC). The director had been purposely removed from and misled about the financial problems of the corporation. By the time she became aware of the financial difficulties, she could not have taken any protective action.

33 In *Cadrin v. The Queen*, 99 DTC 5079 (FCA), the managing partner had hidden problems from the appellant director and had misappropriated funds. See also *Cameron v. The Queen*, 2001 DTC 5405 (FCA), where the director had unwisely relied upon the assurances of management that remittances had been made. The director's defence was successful even though he might have been more attentive to ensure that he was not misled by management.

would rise and outside directors had to act quickly. In these circumstances, the standard was not whether the director actually knew, but whether he or she ought to have known, that a default had occurred. Financial statements or other factors could give rise to suspicion that would be measured on the reasonable person basis.[34]

Family members who become nominal directors out of obligation to the family have usually been classified as outside directors. In such cases, a controlling patriarch might have had no intention of sharing financial information, but only wanted to introduce a younger family member to the operational aspects of the business. For a person appointed in the capacity of a mere nominal director, a lower standard of care has been permitted.[35] Relying upon a family member who has superior abilities in financial aspects of the corporation has been considered sufficient care.[36] In some cases, family dynamics, including circumstances involving reliance and deceit, have reduced the standard of care to low levels.[37]

On the other hand, the Tax Court set the standard for inside directors at the high end of the spectrum. They had a duty to take positive action to prevent a failure to remit source deductions. But perfection was not the standard.[38] Inside directors were not guarantors of debts to the Crown, nor was the impossible demanded. Emphasis was placed upon the conduct of the directors, and even at the high end, it was measured on the reasonable person basis.

Thus, the standard for inside directors was not unduly stringent, but was measured by reasonableness. A director's conduct would be the central focus in light of his actual knowledge or what he ought to have known. For example, remaining completely uninterested or passive with respect to the duty to remit, or being wilfully blind as to the real circumstances, was not reasonable.[39] Even though not an insurer, an inside director should be able to point to safeguards put in place to ensure that a default had not occurred.[40] Reasonableness encompassed conduct that was not always

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34 In *Elias v. The Queen*, [2002] 1 CTC 2764 (TCC), there was nothing in the corporation's financial statements to indicate that remittances were not being paid. In *Henning v. The Queen*, 98 DTC 3452(S) (TCC), there was nothing in the evidence based on the available financial information to indicate that the director ought to have known that there was a problem or a potential problem with remittances. Slow payment of corporate suppliers was sufficient to prompt suspicion in *Mariani v. The Queen*, 2002 GTC 328 (TCC). See also *Potvin v. The Queen*, 2003 GTC 708 (TCC); and *Mann v. The Queen*, 2004 TCC 741.

35 *Direnzo v. The Queen*, 2000 DTC 2230 (TCC); and *Lambert v. The Queen*, 2003 GTC 899-79 (TCC).

36 *Kenny v. The Queen*, 2001 GTC 315 (TCC).

37 *Forgione v. The Queen*, 2005 TCC 381.

38 *Cameron*, supra note 33; *Cassels v. The Queen*, [2001] GSTC 122 (TCC); and *Lau et al. v. The Queen*, 2002 DTC 2212 (TCC). See also *Fremlin v. The Queen*, 2002 DTC 3893(S) (TCC), where it was noted that stringent standards have been modified.

39 *Dipede v. The Queen*, 2004 TCC 100; *Woo v. The Queen*, 2002 GTC 166 (TCC); *Tenn-Yuk v. The Queen*, 2004 TCC 243; and *McGowen v. The Queen*, 2005 TCC 353.

40 *Garland v. The Queen*, 2004 TCC 494.

successful, but deferment of remittances in the hope that the business of the corporation would be better in the future was an unwarranted gamble that fell below the acceptable threshold of care.[41]

Inside directors were expected to have a higher degree of knowledge, particularly with respect to the corporation's finances. If a director did not know what financial statements indicated, then it would only be reasonable to question the corporate accountant or others.[42] Once a director was in possession of knowledge, not only would diligence require him to take positive steps to prevent a default, but action independent of and possibly contrary to a controlling principal could be required.[43] Internal controls that impeded the free flow of information to a director would not excuse the requirement to take corrective action.[44] Assumptions with respect to knowledge, such as the sufficiency of assets in the hands of a trustee to pay creditors, would be determined on the basis of reasonableness.[45]

The classification of directors as either outside or inside has not been rigid. A shift between categories might occur owing to a change in circumstances. In such cases, the standard of care has likewise shifted. Thus, an outside director who attempted to keep a corporation afloat by becoming more involved in day-to-day management was reclassified as an inside director with a higher standard of care.[46] A shift to inside status might come about even though a director's knowledge of the corporation's business had not changed but the membership of the board of directors had, by reason of a resignation.[47] In such circumstances, the onus of asking more detailed questions relevant to the corporation's business would arise.

The subjective standard has been applied at both ends of the spectrum. At the low end, doing one's best has not been sufficient to invoke a successful defence under subsection 227.1(3). However, at the high end, a professional standard could be expected, particularly from inside directors. A high degree of diligence could be expected from a director who is a lawyer by profession, who teaches corporate law, or who has significant business acumen.[48] Reliance on an outside corporate manager is not sufficient diligence in the absence of adequate controls over corporate obligations to prevent defaults of source deductions.

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41 *Cameron*, supra note 33. See also *Cassels*, supra note 38; and *Birchard v. The Queen*, 2003 TCC 90.

42 *Redmond v. The Queen*, 2000 GTC 782 (TCC); and *Ashton v. The Queen*, 2001 GTC 300 (TCC).

43 *Hamilton v. The Queen*, 2004 DTC 2860 (TCC).

44 *Matossian et al. v. The Queen*, 2005 DTC 357 (TCC).

45 *The Queen v. Corsano et al.*, 99 DTC 5658 (FCA). The fact that the value of corporate assets exceeded claims of all creditors did not discharge the directors' burden to take action pursuant to subsection 227.1(1). See also *Fremlin*, supra note 38, and *Clements v. The Queen*, 2003 TCC 289.

46 *Smith v. The Queen*, 2001 DTC 5226 (FCA). A sliding or shifting standard had been suggested as early as 1991 in *Sheremeta*, supra note 18.

47 *Weyand v. The Queen*, 2004 TCC 355. See also *Binavince v. MNR*, 91 DTC 1225 (TCC), for the pre-*Soper* period.

48 *Lassonde v. The Queen*, 98 DTC 2218 (TCC); and *Wiseman v. The Queen*, 2002 DTC 3879(S) (TCC).

The Tax Court of Canada has always reserved its right to exercise discretion in the application of the standard of care, diligence, and skill. The court has employed common sense and fairness with regard to the circumstances as found in particular cases. Any unforeseen or unexpected event might prompt the court to short-circuit the application of the standard of care and focus on reasonableness in the circumstances.[49] The court itself has taken the initiative to search for any additional action that the director could have taken in the circumstances. Thus, it was not unreasonable for a director who could not testify because of trauma inflicted by a beating during a robbery to have failed to prepare and file goods and services tax (GST) returns.[50] The circumstances of the case allowed the court to reassess and reduce liability for outstanding GST.

THE IMPACT OF PEOPLES

The Supreme Court of Canada indicated in *Peoples* that it preferred the objective standard. This was a change from the all-encompassing objective-subjective standard articulated in *Soper*. Given the impact that *Soper* has had as the seminal case under subsection 227.1(3) of the Income Tax Act, *Peoples* has mandated a change of course for the due diligence defence. The Tax Court has always recognized the importance of the factual aspects of the circumstances and the emphasis to be placed on prevailing socioeconomic conditions. Thus, only the application of the statutory standard of care has changed, not the considerations taken into account.

How, specifically, will this change affect the due diligence defence under subsection 227.1(3)? The only standard applied will be the objective one. That is to say, what care, diligence, and skill would a reasonably prudent person have exercised to prevent the failure in comparable circumstances? Education, training, ability, and experience may well be primary facts, but they are not considerations governing the standard to be applied. They may affect the level of care, diligence, and skill, but the prime consideration will be the individual director's knowledge of the corporation's finances. This knowledge will be determined by the actual or assumed operational and administrative responsibilities of a director within the corporation. If the director had no actual knowledge of a default, the court's inquiry should be directed to whether the director ought to have obtained such information so that the required action could have been taken to prevent the default.

When the objective standard is applied, the "inside" and "outside" classification of directors ceases to have importance. In *Soper*, it was only the starting point or first level of inquiry, but normally this methodology led the Tax Court to apply one

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49 *Worrell v. The Queen*, 98 DTC 1783 (TCC). The court noted that termination of the business was not reasonable because it was neither commercially realistic nor morally defensible, in that the appellant would have had to abandon the business and leave the employees and their families in the lurch.

50 *Wiens v. The Queen*, 2003 TCC 491. The challenge with this type of decision is that it is fact-driven and not decided upon articulated principle.

standard or the other. The only purpose now served by such classification is to determine whether the action taken to prevent a default was commensurate with the knowledge possessed. With respect to the application of the objective standard, the inquiry would be not only what knowledge was actually possessed, but what knowledge ought to have been possessed. Position and involvement in corporate affairs would be prime considerations.[51] Thus, the categories posited in *Soper* would not be relevant to the standard as stated in *Peoples*.

It is now arguable that the expectations in respect of a director's knowledge of remittance requirements and the detection of defaults have increased. Personal limitations requiring the application of the subjective standard of care are no longer available. Will greater vigilance be required on the part of directors who are hands-on workers with little formal education and no involvement in the administration or financial management of the corporation? Will reliance on people who have the knowledge not possessed by a director be sufficient to meet the objective standard? Will inability to read or speak either English or French be relevant? The degree of care, diligence, and skill is that of the reasonable person, not of a group of individuals with personal attributes similar to those of the particular director.

It may be that a director now has to be more diligent and more careful in relying on others. One of the reasons for the adoption of the subjective standard in *Soper* was that there were few minimum qualifications to be met for a person to become a director. This assumption may not be as relevant today as it was when *Soper* was decided. Courses for high-end directors are now available through institutes and universities.[52] There are now greater supports for a director who must depend upon the knowledge base of others. Given that there have been over 450 cases dealing with directors' personal liability for failure to remit source deductions or GST, accountants and lawyers are much more familiar with the requirement to deduct or collect, and to remit payments in a timely manner. Software programs are available to process the amounts required for remittance. Outside parties are available to process payroll and make remittances by contract. Reliance upon persons or systems to provide the knowledge and capability that a director lacks will be tested on the reasonableness basis. There now are computer systems upon which it would be reasonable to rely. As time goes on, it will be more difficult for even a non-administrative director to argue that he could not have known of the duty to remit or even that a default has occurred.

The second justification for adopting the subjective standard in *Soper* was that directors had to exercise business judgment and take business risks. It has to be noted

51 *Sziklai v. The Queen*, 2006 TCC 68. Instead of categorizing directors as "outside" or "inside," the court reformulated the question: "[T]he issue might be better posed by asking more simply whether the Appellant was, by virtue of his position and involvement, in a position to detect the potential problem and deal with it" (ibid., at paragraph 12). In this case, the court drew the line at the point in time when the appellant would reasonably have known of the default if he had been diligent, and found that he should be given a grace period of three months.

52 See, for example, the Directors' Education Program offered by the Institute of Corporate Directors, online at http://www.icd.ca/.

that there is no business judgment per se in the duty under subsection 227.1(3). The scope of the duty is "to prevent the failure [default]." Whatever tangential business decisions may have been made with respect to the ability of the corporation to remit source deductions and GST, there is no discretion with respect to the obligation to remit. The only "risk" involved is that the corporation might not be able to meet its obligation to remit on time. Besides, use of source deductions as funds for other business purposes was the very "mischief" that subsection 227.1(1) was meant to cover.[53] Thus, justification of the application of the subjective standard on this basis has always been questionable. Nor does the duty under subsection 227.1(3) compel the corporation to make a business decision to minimize liability for GST.[54]

Will the preference for the objective standard as stated in *Peoples* have an impact on a director who holds office in a family context? The business and administration of a corporation may be dominated by an uncompromising patriarch, and family harmony may become interwoven with legal responsibilities to outsiders; or there may be blind devotion to a son or daughter who controls the financial affairs of the business. In such circumstances, a director may be appointed who is unsophisticated in commercial matters and has little or no knowledge of management or administration of the business. In some cases, a patriarch may not wish to share financial responsibilities with a young family member whose role is to learn about operations from an elder.

The jurisprudence in such circumstances has not been consistent. Some decisions have applied the subjective test and noted that the director was merely passive, nominal, outside, or lacking the power to prevent defaults.[55] Others have applied the objective test and noted that merely becoming a director in a family context was not sufficient reason to ignore the responsibilities of a director or to fail to ask fundamental questions as to what those responsibilities were.[56] The resolution of issues involving family appointments as directors will continue to be difficult with the application of only the objective standard. Considerations of compassion, coercion, and the realities of family relations are "circumstances" that could be perceived to

53 *Barnett*, supra note 16, at 620 (TCC).

54 *O'Keefe v. The Queen*, 2006 TCC 250. The appellant was a director of both a vendor and a purchaser of wood. The Crown unsuccessfully argued that the director should have stopped the purchaser from buying because that only increased the tax liability of the vendor. The court was of the opinion that such a theory was flawed and that the appellant was powerless in the circumstances to make the vendor corporation pay the tax.

55 *Fitzgerald et al. v. MNR*, 92 DTC 1019 (TCC); *Taillefer et al. v. The Queen*, 95 DTC 462 (TCC); *Gregory*, supra note 18; *Whitehouse v. The Queen*, 2000 GTC 682 (TCC); *Hevenor v. The Queen*, 99 GTC 3070 (TCC); *Direnzo*, supra note 35; *Maheux v. The Queen*, 2000 GTC 742 (TCC); *Fremlin*, supra note 38; *Lambert*, supra note 35; *MacIssac v. The Queen*, 2004 TCC 618; *Corkum v. The Queen*, 2005 TCC 755; and *Forgione*, supra note 37.

56 *Hanson v. The Queen*, 97 DTC 796 (TCC); aff'd. 2000 DTC 6564 (FCA); *Starkman v. The Queen*, 97 DTC 200 (TCC); and *Woo*, supra note 39.

affect the actions or lack thereof of the reasonable person.[57] The credibility of evidence from family members will be vital to the determination of whether due care has been exercised.

What advice should a tax practitioner give a client in circumstances where a family member is to be appointed as a nominal or passive director? The best advice would be to recommend against any such appointment. However, this position might not be well received by the controlling shareholder. If family members are already directors, it would be virtually impossible to insist that they step aside because of increased potential liability. On the other hand, nominal or passive family directors could feel that they had not been properly advised if they incurred subsequent liability.

Although there is no requirement to do so, it might be prudent for a tax practitioner to request that family members who are to be passive or nominal directors obtain independent legal advice. Financial institutions have required independent legal advice in mortgage transactions.[58] In other areas, where third parties have claimed against a person, either independent legal advice or counselling has been imperative. An individual who has been declared bankrupt is required to receive compulsory counselling under the current Bankruptcy and Insolvency Act.[59] For family directors, because legal advice would be given directly, they would be apprised of potential liability. Such advice would include a review of the due diligence requirements found in *Information Circular* 89-2R2.[60] Independent advice could be quickly arranged and would be relatively inexpensive.

Finally, one might consider it curious that the *Peoples* decision has not been discussed in any decision of the Tax Court of Canada in the last two years. The first recognition was a footnote in a case, where the court indicated that the test for the due diligence defence was an objective one, and that the application of the subjective-objective standard of *Soper* was not relevant to the particular case.[61] Very recently, the court affirmed that the *Peoples* decision has rejected the objective-subjective standard established by *Soper*, but did not apply the *Peoples* decision or discuss its

57 See *Fitzgerald*, supra note 55, at 1021, wherein the court stated, "I emphasize 'in comparable circumstances' because the reasonably prudent person would, in this feudal family, maintain family harmony by serving as a director in name only and by leaving the management of the business in the hands of the strong-minded patriarch who had managed it successfully for 30 years."

58 Financial institutions regularly required a spouse who did not hold title in a mortgaged property to obtain independent legal advice. Today, a spouse is required to obtain independent legal advice when the other spouse is not employed but an entrepreneur.

59 RSC 1985, c. B-3, as amended, section 157.1(1). See also Canada, Office of the Superintendent of Bankruptcy, *Directive* no. 1R2, "Counselling in Insolvency Matters," December 21, 1994.

60 *Information Circular* 89-2R2, "Directors' Liability Section 227.1 of the Income Tax Act, Section 323 of the Excise Tax Act, Section 81 of the Air Travellers Security Charge Act, and Subsection 295(1) of the Excise Act, 2001," March 24, 2006. See paragraphs 11 to 18 for actions that evidence due diligence.

61 *Sziklai*, supra note 51, at note 6.

implications.[62] One might also speculate that another wave of cases with the subsection 227.1(3) defence will not likely occur until (unfortunately) the Canadian economy goes into a recession.

Apart from one case since *Peoples*, the Tax Court of Canada has applied the objective standard whenever the due diligence defence has been argued.[63] However, only the objective component of the standard required by *Soper* has been referred to. In the one case in which the subjective standard was applied, the court concluded, "He exercised prudence . . . to the degree he was able."[64] However, the objective standard was also applied. This case dealt with a director in a family context, and the court was of the opinion that many reasonably prudent people in comparable circumstances would have relied upon an otherwise responsible adult child who had let pride overtake reason and had not been honest with the parent director. The application of the objective standard would have provided greater clarity in principle.

CONCLUSION

Tax practitioners have not yet had the opportunity to argue the standard handed down in *Peoples*, but the Tax Court of Canada has indicated a willingness to adopt the objective standard for the subsection 227.1(3) defence. Applying the objective standard will result in a higher level of care, diligence, and skill to prevent defaults. Outer limits of the conduct and liability of directors, including directors in the family context, still have to be worked out on a case-by-case basis. Application of the objective standard should provide a more uniform and consistent jurisprudence. In special cases, such as directors who are family members, the objective standard can

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62 *Kraeker v. The Queen*, 2007 TCC 31. Miller J, ibid., at paragraph 17, quoted paragraph 67 of the *Peoples* decision that related to the breach of the duty of care for a business decision. In that paragraph, the Supreme Court of Canada merely reaffirmed its reluctance to interfere with a business decision.

63 For example, in *Pagé v. The Queen*, 2005 TCC 213, the Tax Court noted that the appellant was involved in day-to-day activities and was aware of financial difficulties. As an experienced businessman, he should have been alerted to his responsibilities to ensure that source deductions were remitted. Steps that he took toward the relaunch of the corporation had the primary aim of saving his investment rather than preventing the failure to remit source deductions. In *Hartrell v. The Queen*, 2006 TCC 480, the Tax Court noted that the appellant had been a chartered accountant for 30 years and a director in other corporations. He was also an experienced businessman and an inside director involved in day-to-day management. He was aware that remittances were not being made and made a conscious decision not to make them during the relevant period.

64 In *Forgione*, supra note 37, at paragraph 34, Rip J stated, "I would be hard pressed to find that a parent was not duly diligent for the purposes of subsection 323(3) [of the Excise Tax Act] solely because he or she relied on an adult child who was responsible in the past but, due to pride, was not honest with the parent. Many reasonably prudent persons in circumstances comparable to Mr. Forgione would have exercised the same degree, care and diligence that Mr. Forgione did. His skill to have possibly prevented such failure was limited by his background."

still be applied with emphasis on what the reasonable person would have done "in comparable circumstances."

This higher level of care, diligence, and skill is consonant with society's expectations of persons in positions of trust and power, such as directors. One element of this expectation is that of accountability for breach of duty to remit while in the office of director. Perhaps the result is more stress for directors, but fellow taxpayers would merely note that this duty goes with the office.