# Chapter 5

# THE LEGAL CONTEXT OF NONPROFIT MANAGEMENT

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## INTRODUCTION — DEFINITIONS AND LEGAL ENVIRONMENT

Nonprofit organizations come in many shapes and sizes and are referred to in this chapter by different names depending upon the context of the discussion, particularly with respect to the legal environment surrounding the discussion. It is important to recognize that while all charities are nonprofit organizations, not all nonprofit organizations are charities. As such, care should be taken when referring to such organizations. Additionally, despite the growth in number and size of charitable and nonprofit organizations in Canada,[1] changes to the legal framework from both the federal and provincial governments have not kept pace (Bourgeois (2002, at p. 3)), still relying heavily upon concepts developed in the 17th and 19th centuries, thereby leaving the distinction between the various types of charities and nonprofit organizations in a somewhat confused state. This is particularly so for members of the public, who often use the terms of nonprofit organizations and charities interchangeably.

[1] For example, Statistics Canada released the results of its survey of charitable and nonprofit organizations in 2004, which indicated that there were approximately 161,000 such organizations in Canada in 2003. These organizations had revenues totalling $112 billion ($10 billion of which came from individual donations), and they drew upon 2.1 billion volunteer hours and 139 million memberships. See Hall, M.H. *et al.* (2004), at 7, 9 and 10. See also latest survey, Hall, M.H. *et al.* (2009) released by Imagine Canada on June 8, 2009.

## Defining Charitable and Nonprofit Organizations

Both charitable and nonprofit organizations operate on a nonprofit basis in that both must devote all of their resources to their activities and neither may distribute any of their income to their members, officers, directors, or trustees. Both are exempt from tax on their income, with some exceptions for nonprofit organizations, and both will often have similar governance structures. Charitable and nonprofit organizations are, however, two distinct types of legal entities with different legal obligations and rights. An organization which has charitable objects is much more limited in the types of activities it can engage in, but, in return, receives substantial advantages in carrying out its objects by being able to issue charitable receipts for income tax purposes in response to donations that are received.

At law, charity has a specific meaning that often eludes the popular conception. For an organization to be considered charitable at law, its activities must be undertaken to achieve a charitable purpose. At present, only four categories of charity are recognized in Canadian law. In the seminal decision *Special Commissioners of Income Tax v. Pemsel*,[2] Lord MacNaghten identified four "heads" or categories of charity:

- relief of poverty;
- advancement of education;
- advancement of religion; and
- other purposes beneficial to the community not falling under any of the preceding heads.

This definition is generally mirrored in Ontario's *Charities Accounting Act*,[3] and although the *Income Tax Act* ("ITA")[4] does not make specific reference to these categories, both the Charities Directorate of Canada Revenue Agency ("CRA") and the courts rely on the same categories in regulating the sector. The Supreme Court of Canada, in *Vancouver Society of Immigrant and Visible Minority Women v. M.N.R.*,[5] clarified the Canadian approach to recognizing charities, noting that while the ITA focuses on the character of the activity undertaken by the organization, linking them to the categories

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2 [1891] A.C. 531 (H.L.) (Pemsel).
3 R.S.O. 1990, c. C.10 (CAA).
4 R.S.C. 1985, c. 1 (5th Supp.) as amended.
5 [1999] S.C.J. No. 5, [1999] 1 S.C.R. 10 (*Vancouver Society*).

established in *Pemsel*, the focus should be on the purpose in furtherance of which an activity is carried out in order to determine whether charitable status should be granted. An organization with objectives and activities that fall into one of these four categories will qualify as a registered charity for the purposes of the ITA. As we discuss in further detail below, a registered charity may take one of three legal forms depending upon the types of activities undertaken and the relationship between the organization and its main source of funds: a charitable organization, a public foundation, or a private foundation.

Under the ITA, a "nonprofit" organization is defined as a

> … club, society or association that … was not a charity … and that was organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit, no part of the income of which was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder … .[6]

The ITA clearly establishes that, for its purposes, nonprofit organizations and charities are two mutually exclusive categories of organizations. As such, any organization whose objectives and activities fall exclusively within the four categories of charity discussed above is not a nonprofit organization and should seek registration as a charity under the ITA in order to avoid being taxed on its income. Although a nonprofit organization, like a charity, has tax-exempt status and does not pay tax on income or capital gains (except income from property of an organization whose main purpose is to provide dining, recreation, or sporting facilities),[7] the nonprofit organization is not able to issue charitable receipts to donors for income tax purposes. However, it is not required to disburse a specified percentage of its earnings as a charity is required to do in accordance with its disbursement quota.

For example, in a recent decision of the Supreme Court of Canada ("SCC"), the Court considered whether an Ontario amateur youth soccer association qualified as a registered charity within the meaning of the ITA. The letters patent provided, in part, that the organization had the following objects:

(a) to fund and develop activities and programs to promote, organize, and carry on the sport of amateur youth soccer;

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6 ITA, s. 149(1)(*l*).

7 ITA, s. 149(5)(*e*)(ii).

(b) to fund, promote, and develop local amateur youth soccer programs and coaching appropriate to different age groups and different levels of ability to increase participation in the sport of soccer;

In *A.Y.S.A. Amateur Youth Soccer Association v. Canada (Revenue Agency)*,[8] the Court found that the promotion of amateur sports, in and of itself, was not a charitable purpose and that sports organizations may only become registered as a charity if sport is ancillary to another recognized charitable purpose, such as education or relief of the disabled. As a result, most sports organizations do not qualify as registered charities and will be considered nonprofit organizations.[9] Other examples of nonprofit organizations include recreation or hobby groups, social clubs or fraternal lodges, certain music or arts festival organizations, professional or political organizations, and many others.

## LEGAL ENVIRONMENT

Added to the confusion of language, which is often misunderstood and misused, is a legal environment which is also confused and underdeveloped. According to Donald Bourgeois (2002, at p. 5):

> The confusion in the law and the failure to amend the statutory provisions to address and to take into account changes in society has made it more difficult for directors, officers and members to understand their legal obligations and roles. Individuals who participate in charitable and not-for-profit organizations are, for the most part, sincere in their attempts to make improvements to society, communities and institutions. They are not as often prepared for the potential legal, financial and practical consequences of their involvement. They may be "at sea" and unsure of what steps to take to address problems or issues.

Contributing to this confusion is a patchwork of federal and provincial legislation which has not been modernized. Instead, problems have been addressed through policies and practices that have developed over time. At the federal level, significant changes have been made and proposed with respect to the regulation of charities. Following

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8 [2007] S.C.J. No 42, 2007 SCC 42 (S.C.C.).

9 Note that the ITA provides a specific tax exemption for registered Canadian amateur athletic associations ("RCAAAs"). The definition of a RCAAA found in subsection 248(1) of the ITA requires that the association promote amateur athletics on a national level and that the association qualify as a nonprofit corporation in accordance with paragraph 149(1)(*l*) of the ITA.

years of policy development, public consultation, and legislative drafting, a new *Canada Not-for-Profit Corporations Act* was introduced in Parliament in 2004.[10] It is intended to replace Parts II and III (which govern federal non-share capital corporations) of the *Canada Corporations Act* ("CCA")[11], which was first enacted in 1917 and substantively unchanged since that time. The proposed changes aim to provide a more flexible process for incorporating and governing nonprofit corporations.

## Applicable Federal and Provincial Legislation

There is a plethora of legislation that is applicable to both charitable and nonprofit organizations, whether it is at the federal or provincial level, and the directors and members of these organizations must be aware of how the legislation will impact on their operations.[12] Although space does not permit a full discussion of the applicable legislation, the following provides a brief summary of some of the more important pieces of it.

### *Income Tax Act*

In addition to determining whether an organization is a charitable or nonprofit organization, the ITA places certain obligations upon directors of organizations, some of which continue for a period after the individual ceases to be a director. Directors are not only liable for ensuring employee source deductions are remitted to the government, they must also ensure the charity complies with numerous reporting requirements. Directors may also face fines and imprisonment where they are involved in making false or deceptive statements in any return required under the ITA or willfully evading compliance with the ITA. To avoid liability, a director needs to show that positive steps were taken to ensure that the corporation complied with the ITA's requirements. The ITA has corresponding regulations[13] that must also be complied with.

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[10] See Burke-Robertson (2005, 2008). The new *Canada Not-for-Profit Corporations Act*, Bill C-4, was first introduced in November 2004, but died when Parliament prorogued for the 2006 election. The Bill was later reintroduced a number of times and received Royal Assent on June 23, 2009. At the time of writing, it had not yet come into force.

[11] R.S.C. 1970, c. C-32.

[12] For a useful resource in this respect, see Hoffstein, Carter & Parachin (2008).

[13] C.R.C. 1978, c. 945.

### *Canada Corporations Act*

The CCA is the statute under which all federal non-share capital corporations are incorporated. The CCA sets out the manner in which the corporation is to be governed, as well as setting out the rights and obligations of directors and members. The CCA has corresponding regulations[14] that must also be complied with.

### *Charities Registration (Security Information) Act*

The *Charities Registration (Security Information) Act*[15] was created by the *Anti-Terrorism Act*. The *Charities Registration (Security Information) Act* is intended to provide a means to ensure that charities do not directly or indirectly fund terrorist activities. In particular, it provides a two-step process whereby a registered charity or an applicant for registered charity status may, respectively, be de-registered or denied charitable registration for supporting terrorist activities.

### *Competition Act*

The *Competition Act*[16] is a federal statute, the purpose of which is to encourage competition and to prohibit unfair business practices. The *Competition Act* currently provides for a variety of rules that regulate the fundraising activities of charities; this includes rules that regulate telemarketing, promotional contests, lotteries, and the making of representations to the public. In addition, any charity carrying on a business activity will be required to comply with the *Competition Act* regarding the manner in which the business activity is carried out.

### *Federal Lobbying Act*

Lobbyist registration legislation has been in place in Canada since the passage of federal lobbyist registration legislation some 20 years ago. The *Lobbyist Registration Act*[17] was the first Canadian legislation to govern the conduct of lobbyists by requiring them to register and file

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14 C.R.C. 1978, c. 424.
15 S.C. 2001, c. 41.
16 R.S.C. 1985, c. C-34.
17 R.S.C. 1985, c. 44 (4th Supp.) as am. by S.C. 1993, c. 12, S.C. 1995, c. 12, S.C. 2003, c. 10 and S.C. 2004, c. 7.

reports to a lobbyist registry. The *Federal Accountability Act*[18] was enacted in December 2006 in an effort to improve the transparency of lobbying and the accountability of government decision-making and soon thereafter the *Lobbying Act*[19] and its accompanying regulations came into force, bringing some new accountability and transparency rules for lobbyists. Many charities and nonprofits are not aware of the existence of these statutes, or are uncertain that some of their programs constitute lobbying and therefore require them to register under these statutes.

### *Provincial Legislation*

Like their federal counterpart, each of the provinces has enacted legislation setting out the requirements for incorporating and maintaining a corporation. Issues concerning directors' rights and obligations are covered in detail.[20] Like its federal counterpart, the Ontario *Corporations Act* is currently undergoing extensive review and new legislation is likely to be introduced is the future.[21]

In Ontario, the *Trustee Act*[22] establishes that directors of a charitable corporation have the power and duty to invest the assets of the corporation as a prudent investor would. This includes the power to invest in mutual funds and the power to delegate investment decision-making to qualified investment managers, provided the corresponding statutory requirements are strictly complied with. Other provinces have similar legislation.[23]

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18 S.C. 2006, c. 9.

19 R.S.C. 1985, c. 44 (4th Supp.) as am. by S.C. 2006, c. 9.

20 See, *e.g.*, British Columbia's *Society Act*, R.S.B.C. 1996, c. 433; Alberta's *Societies Act*, R.S.A. 2000, c. S-14; Saskatchewan's *Non-profit Corporations Act, 1995*, S.S. 1995, c. N-4.2; Manitoba's *Corporations Act*, C.C.S.M., c. C225; Ontario's *Corporations Act*, R.S.O. 1990, c. C.38; Quebec's *Companies Act*, R.S.Q., c. C-38; New Brunswick's *Companies Act*, R.S.N.B. 1973, c. C-13; Nova Scotia's *Companies Act*, R.S.N.S. 1989, c. 81, and *Societies Act*, R.S.N.S. 1989, c. 435; Prince Edward Island's *Companies Act*, R.S.P.E.I. 1988, c. C-14; Newfoundland and Labrador's *Corporations Act*, R.S.N.L. 1990, c. C-36; Yukon's *Societies Act*, R.S.Y. 2002, c. 206; Northwest Territories' *Societies Act*, R.S.N.W.T. 1988, c. S-11; and Nunavut's *Societies Act (Nunavut)*, R.S.N.W.T. 1988, c. S-11.

21 Carter, Terrance S. *Charity Law Bulletin Update April 2008*, available online at: <http://www.carters.ca/pub/update/charity/08/apr08.pdf>.

22 R.S.O. 1990, c. T.23.

23 See, *e.g.*, Alberta, R.S.A. 2000, c. T-8; British Columbia, R.S.B.C. 1996, c. 464; Saskatchewan, R.S.S. 1978, c. T-23; Manitoba, C.C.S.M., c. T160; New Brunswick, R.S.N.B. 1973, c. T-15; Nova Scotia, R.S.N.S. 1989, c. 479; Prince Edward Island, R.S.P.E.I. 1988, c. T-8; Newfoundland and Labrador, R.S.N.L. 1990, c. T-10; Yukon, R.S.Y. 2002, c. 223; Northwest Territories, R.S.N.W.T. 1988, c. T-8; and Nunavut, R.S.N.W.T. 1988, c. T-8.

### *Provincial Legislation Aimed at Regulating Charities*

There are a few provinces with statutes aimed at regulating the charitable sector. Some of Ontario's statutes include: the *Charities Accounting Act*,[24] the *Charitable Institutions Act*,[25] and the *Charitable Gifts Act*.[26] In addition to setting out the requirements for operating a charity, these Acts limit the activities in which a charity may participate. Failure to conform to the requirements of these Acts may result in the province cancelling the corporation's letters patent and liability for the directors. Alberta regulates the fundraising activities of charities through the *Charitable Fund-raising Act*,[27] while Saskatchewan's *Charitable Fund-raising Businesses Act*,[28] focuses its attention on fundraising businesses, not charities. Manitoba regulates fundraising activities through the *Charities Endorsement Act*,[29] requiring ministerial authorization to solicit funds. Prince Edward Island's *Charities Act*[30] makes distinctions between solicitations by charities and appeals by religious institutions (churches, synagogues, mosques, *etc*.) for financial support.

As legislation is not uniform across the country, charitable and nonprofit organizations should enquire as to the governing legislation in their own jurisdiction. These will be in addition to any laws of general application which also apply to the activities of nonprofit organizations.

## LEGAL STRUCTURES FOR NONPROFIT ORGANIZATIONS

### Overview of Types of Legal Structure

Just like a for-profit business, a nonprofit organization must determine the appropriate legal structure to meet its needs. Not all nonprofit

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24 R.S.O. 1990, c. C.10.

25 R.S.O. 1990, c. C.9.

26 R.S.O. 1990, c. C.8. Other Ontario legislation dealing with charitable or not-for-profit organizations includes: *Donation of Food Act, 1994*, S.O. 1994, c. 19; *Hospitals and Charitable Institutions Inquiries Act*, R.S.O. 1990, c. H.15; *Religious Organizations' Lands Act*, R.S.O. 1990, c. R.23; *University Foundations Act, 1992*, S.O. 1992, c. 22; *Approved Acts of Executors and Trustees*, O. Reg. 4/01, made pursuant to the *Charities Accounting Act*; and the *Corporations Act Regulation (General)*, R.R.O. 1990, Reg. 181.

27 R.S.A. 2000, c. C-9.

28 S.S. 2002, c. C-6.2.

29 C.C.S.M., c. C60.

30 R.S.P.E.I. 1988, c. C-4.

organizations are created equal, and as such Canadian law provides four different legal structures for nonprofit organizations: a trust; an unincorporated association; a corporation without share capital; or a co-operative without share capital. Not only will the legal structure chosen dictate the rights and responsibilities of the organization and its directors, it may also impact on donations and grants from other bodies. When starting a nonprofit organization, the organizers must consider a number of factors in order to choose the necessary structure to carry out its goals. The factors to consider include (see Burke-Robertson & Drache (2002, at pp. 1-3)):

- the objectives of the proposed organization;
- whether the objectives will be of short or long duration;
- the proposed size of membership (if any);
- whether the organization will be of national or local concern;
- whether the organization will be called upon to enter into contracts or hold real property;
- whether it will incur debts or liabilities for which the contracting members or directors may be personally liable;
- the tax treatment of the organization; and
- whether registration as a charity is desired because of ability to issue receipts or because funders require it.

Once these factors are determined, the various legal structures should be examined in order to assess their advantages and disadvantages in relation to the needs of the organization.

As Burke-Robertson notes, "the appropriate form of legal structure may also be dictated by the existing legislation and regulations governing the activities of the particular type of not-for-profit organization" (pp. 1-3). For example, if one is organizing an agricultural society in Manitoba, they must refer to the requirements under the *Agricultural Societies Act*.[31]

### *Trusts*

The trust is one form of legal vehicle for charitable organizations, which, because of its greater flexibility and fewer administrative

[31] C.C.S.M., c. A30.

burdens, may be seen as an attractive alternative for organizations that are made up of only a few people. The option of a trust is not available to nonprofit organizations by virtue of the definition in paragraph 149(1)(*l*) of the *Income Tax Act (Canada)*. While many academics consider the nature of a trust to be hard to define, it is generally regarded as the relationship between the settlor (the donor) and the trustee, where the trustee holds the trust property for the benefit of some persons or for some objectives in such a way that the real benefit of the property accrues to the beneficiaries of the trust rather than the trustee (see Waters (2005, at pp. 3-4); Radu (2009, at pp. 128-30)). While the trustee's actions are governed by the *Trustee Act*,[32] in order for the trust property to vest in the trustee, the trust must meet the common law requirements. To properly be recognized as a trust, the trust document or instrument must include what the courts refer to as the three certainties: certainty of intention, certainty of subject-matter, and certainty of objects.[33] This requires the trust document to set out the purposes or objectives of the trust, the property to be held in trust, and to identify the beneficiaries of the trust or a means by which to determine who will be the beneficiaries (Waters (2005, at pp. 132 ff.)).

In situations where there will be a limited number of individuals wishing to aid in the administration of a nonprofit or charitable endeavour, a trust is a useful vehicle, as involvement in the trust is limited to the trustees. For example, the Kadey Family Charitable Trust is administered by two members of the Kadey family, and the David J. Daniels Foundation is administered by one member of the Daniels family and two arm's-length trustees.[34] Although the trust is a convenient vehicle, both statutory and common law requirements place substantial fiduciary obligations upon the trustee, including the following three fundamental duties (Waters (2005, at p. 852)):

> First, no trustee may delegate his office to others; secondly, no trustee may profit personally from his dealings with the trust property, with the beneficiaries, or as a trustee; thirdly, a trustee must act honestly and with that level of skill and prudence which

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[32] *Trustee Act*, R.S.O. 1990, c. T.23; *Trustee Act*, R.S.A. 2000, c. T-8; *Trustee Act*, R.S.B.C. 1996, c. 464; *Trustee Act*, R.S.S. 1978, c. T-23; *Trustee Act*, C.C.S.M., c. T160; *Trustees Act*, R.N.B. 1973, c. T-15; *Trustee Act*, R.S.N.S. 1989, c. 479; *Trustee Act*, R.S.P.E.I. 1978, c. T-8; *Trustee Act*, R.S.N.L. 1990, c. T-10; *Trustee Act*, R.S.Y. 2000, c. 223; *Trustee Act*, R.S.N.W.T. 1988, c. T-8; *Trustee Act* (Nunavut), R.S.N.W.T. 1988, c. T-8.

[33] *Faucher v. Tucker Estate*, [1993] M.J. No. 589, [1994] 2 W.W.R. 1 (Man. C.A.).

[34] See 2007 Registered Charity Information Return for the Kadey Family Charitable Trust and the 2007 Registered Charity Information Return for the David J. Daniels Foundation, available online at: <http://www.cra-arc.gc.ca/tx/chrts/menu-eng.html>.

> would be expected of the reasonable man of business administering his own affairs.

Although there are statutory provisions governing trust documents and duties of trustees, and the common law related to the administration of trusts has developed over hundreds of years, the primary terms of a trust are to be found within the trust document itself. Apart from the general duties imposed by law, the trustee must follow the terms of the trust or risk allegations of breach of fiduciary duty.

### *Unincorporated Association*

An unincorporated association is defined as "a group of two or more persons united together by mutual consent in order to determine, deliberate and act jointly for a common purpose" (CED (2005, at §1)).[35] In many respects, it is like a business partnership, however, it is not formed for the purposes of profit.[36] In an unincorporated association, the members may be governed by a contractual arrangement, which is commonly referred to as a "Memorandum of Association" or a Constitution. Both documents set out the purpose or "objects" of the organization and how it is to be managed or operated, providing great latitude for the creation of an organization since the only limitation is that the objects must be lawful. For example, the Dalhousie Law School Alumni Association has the following Memorandum of Association:[37]

**MEMORANDUM OF ASSOCIATION**
**OF**
**DALHOUSIE LAW SCHOOL ALUMNI ASSOCIATION**

1. The name of the Society is Dalhousie Law School Alumni Association.
2. The objects of the Society are:-
   (a) to promote and encourage the active participation of graduates of Dalhousie Law School in the affairs of the School;

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35 See also *Orchard v. Tunney*, [1957] S.C.R. 436.

36 A partnership is not a structure available to either a nonprofit or charitable endeavour because, at law, a partnership requires a profit-making intention.

37 See Dalhousie Law School Alumni Association, "*Memorandum of Association of Dalhousie Law School Alumni Association*", available online at: <http://law.dal.ca/Alumni_and_Friends/Dalhousie_Law_Alumni_Association/Who_We_Are/Memorandum_and_Bylaws/index.php>.

> (b) to promote legal research and legal education particularly at Dalhousie university;
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> (c) to enable graduates of Dalhousie Law School to establish and maintain strong interrelationships between themselves and with Dalhousie Law School;
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> (d) to acquire by way of grant, gift, purchase, bequest, devise, or otherwise, real and personal property and to use and apply such property to the realization of the objects of the Society;
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> (e) To buy, own, hold, lease, mortgage, sell and convey such real and personal property as may be necessary or desirable in the carrying out of the objects of the Society.
>
> PROVIDED that nothing herein contained shall permit the Society to carry on any trade, industry or business and the Society shall be carried on without purpose of gain to any of the members and that any surplus or any accretions of the Society shall be used solely for the purposes of the Society and the promotion of its objects.
>
> PROVIDED, further, that if for any reason the operations of the Society are terminated or are wound up, or are dissolved and there remains, at that time, after satisfaction of all its debts and liabilities, any property whatsoever, the same shall be paid to some other charitable organization in Canada, having objects similar to those of the Society.

As is demonstrated by the above example, a Memorandum of Association must include a clause stating that no gain, dividends, or income will be paid to members of the organization, and that all profits or any income must be used to promote the organization's objects. The nonprofit organization's objects cannot include the carrying on of a profit-making business.

Unlike some of the other legal structures that are available for nonprofit organizations, an unincorporated association does not have the legal capacity to sue or be sued.[38] The contractual nature of the organization creates a legal relationship among the members, but does not create a legal person (Bourgeois (2002, at p. 37)).[39]

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[38] See, *e.g.*, *S. (J.R.) v. Glendinning*, [2000] O.J. No. 2695, 191 D.L.R. (4th) 750 (Ont. S.C.J.).

[39] See also Bourgeois (2008).

### *Corporation without Share Capital*

A corporation without share capital (or a non-share capital corporation) is akin to the traditional corporate structure, except that the members (who are similar to shareholders) do not benefit financially from the organization. A corporation without share capital can be incorporated federally, under the CCA, or provincially, under the applicable provincial corporate legislation. The decision to incorporate federally or provincially (or both) will be determined by the organization's objects, the legislative authority under which they fall, and the scope of the organization's activities, *i.e.*, whether it is a local organization or one crossing multiple jurisdictions. It should be noted that incorporation by letters patent is a privilege and not a right and, as such, the government is able to exert more control over a corporation without share capital.

Although terminology and procedure will vary from jurisdiction to jurisdiction, in order to become a corporation without share capital, multiple persons[40] must make an application for letters patent to the appropriate authority (*i.e.*, either a Minister or Lieutenant Governor) under the applicable legislation.[41] In order to obtain letters patent, the organization must set out the objectives of the corporation, which will form its boundary with share capital's legal capacity to undertake activities. If the objectives are deficient, the only way to change them is through an application for supplementary letters patent. As such, careful consideration must be given to the drafting of the objectives in order to ensure all activities will be covered. As will be discussed in greater detail below, the process of incorporation results in the creation of a separate legal person and provides the members with protection from liability.

### *Co-operative without Share Capital*

A co-operative without share capital (such as a nonprofit housing co-operative) is a special type of corporation, which in Ontario is created under the *Co-operative Corporation Act*.[42] Although co-operatives both with and without share capital are intended to be operated "as

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[40] The exact number of persons required to incorporate depends on the jurisdiction. For example, to incorporate federally, three or more persons are required, whereas in British Columbia, five or more persons are required to incorporate a Society.

[41] The one exception to this is the utilization of an "unlimited liability company" in Nova Scotia, under the *Companies Act*, R.S.N.S. 1989, c. 81.

[42] R.S.O. 1990, c. C.35.

nearly as possible at cost",[43] a co-operative without share capital cannot distribute any surplus or dividends to its members, unlike a co-operative with share capital. Co-operatives without share capital must be organized, operated, and administered according to basic principles set out in the legislation: each member or delegate has only one vote, and no member or delegate may vote by proxy.[44] Provisions enabling a small fixed percentage of any surplus to be distributed to members do not apply to a co-operative without share capital. The legislation also places restrictions on the conversion or dissolution of such corporations; upon dissolution the remaining assets can only be distributed to similar organizations or charitable organizations.

## Advantages and Disadvantages of Different Legal Structures

One of the primary advantages of organizing as a nonprofit organization, regardless of its structure, is being exempt from income tax imposed under the ITA.[45] A charitable organization is also exempt from income tax.[46]

Apart from the income tax benefits that accrue by obtaining nonprofit status, the advantages and disadvantages of the different legal structures should be examined in order to determine if the structure is appropriate for the needs of the organization. Some of the important considerations include set-up costs, legal capacity, liability, and perpetual existence.

### *Set-up Costs*

As would be expected, the more formal the organization's legal structure, the more expensive it will be to establish. Accordingly, a trust or unincorporated association is relatively inexpensive to set up as compared to the cost of the incorporation process for a corporation without share capital or a co-operative without share capital. However, there are significant benefits in choosing the corporation options as outlined below.

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43 *Ibid*., s. 1(1) "co-operative basis".
44 *Ibid*.
45 ITA, s. 149(1)(*l*).
46 ITA, s. 149(1).

### *Legal Capacity*

Legal capacity refers to the organization's ability to be recognized at law, *i.e.*, whether it is a separate legal entity with the capacity to commence or defend a lawsuit, enter into contracts, or own land in its own name. Without delving into legal theory, only a "person" can have rights and responsibilities. Incorporated entities are recognized by law as "persons" capable of obtaining these rights and responsibilities. Although in some respects a trust is considered a separate entity (*i.e.*, for income tax purposes) for many other purposes the trust is not considered a legal entity (Bucknall (2002)).[47] Rather it is considered a relationship between the trust property, the trustee who holds legal title to the property, and the beneficiaries of the trust who hold equitable title to the property. Since the trust property vests in the trustee, there is no trust without the trustee. As such, the trust can only sue, be sued or enter a contract through the trustee who performs these actions on behalf of the trust. An unincorporated association is also not a legal entity, and therefore is incapable of holding title to property or exercising any other legal rights. Property is held in trust and legal acts are carried out by individual members of the group whose actions would be governed by the by-laws of the association.

The main advantage of having a separate legal entity incorporated for the purpose of carrying on charitable or nonprofit activities is that it is the entity which will enter into contracts or carry out the activities and, therefore, the entity which may ultimately be sued for any damages caused by the entity, thus providing some protection for individual trustees and members against future liability. In other words, failure to obtain legal capacity for the organization means the individual members will be personally liable for any damages resulting from the organization's activities as the organization will not have the capacity to be sued.

### *Liability (Organization, Directors, Officers, Members)*

Liability can come in many forms, whether it is for failure to follow statutory rules, breach of contract, negligence, or intentional harm. Whether individual members, directors, or the organization will be held responsible will depend on the legal structure. As a separate legal entity, an incorporated corporation without share capital will be held

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[47] See also *United Service Funds v. Richardson Greenshields of Canada Ltd.*, [1987] B.C.J. No. 1391, 40 D.L.R. (4th) 94 (B.C.S.C.).

answerable and responsible for any act, default, obligation, or liability of the corporation, and the individual members are absolved of responsibility.[48] This does not mean that directors or officers can escape liability, as personal liability may arise in the execution of their duties where their conduct falls below the prescribed standard of care (Burke-Robertson & Drache (2002, at p. 6-3)); see also Bourgeois (2008, at pp. 327-31), and Carter (2002)). Although the duties of a trustee are similar in nature to those of the director and officer, a trustee's exposure to liability is greater as he or she is the only legal person in the trust and is generally held to a higher standard of care. In addition, a trustee will only be reimbursed for those expenses that are properly incurred. Expenses that are improperly incurred become the sole responsibility of the trustee (Waters (2005, at p. 1151)). Members are at greatest risk in an unincorporated association, "which has no legal status apart from that of its members". As such, an association cannot incur liabilities or be convicted of an offence; instead, the members of an unincorporated association may be held personally liable for the acts or omissions of the organization.

### *Perpetual Existence*

As a separate legal entity, the incorporated corporation without share capital can, theoretically, have perpetual existence, so that changes in the membership will not affect its continuity. Similarly, there are provisions in the *Trustee Act* to appoint successor trustees when a trustee dies, retires, refuses to act, or is incapable of acting.[49] An unincorporated association on the other hand cannot have perpetual existence as it is indistinguishable from its members. When the members no longer exist, neither does the association.

As a result of the advantages noted above, specifically relating to the protection from liability and perpetual existence, incorporation is generally preferred.

## National Nonprofit Corporate Structures[50]

The business sector has utilized multiple corporations for years to contain liabilities and to protect assets. Charitable and nonprofit

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48 See, *e.g.*, *Corporations Act*, R.S.O. 1990, c. C.38, s. 122.

49 *Trustee Act*, R.S.O. 1990, c. T.23, s. 3.

50 See Carter (1998; 2001); Godel (2007).

corporations, though, have been generally slow to establish and implement multiple nonprofit corporations to the same end. The traditional use of a corporation by charities has been focused almost exclusively on obtaining limited liability protection for its members, and very little thought has been given to the benefits associated with carrying on operations within a separate corporation in order to contain liabilities and to protect charitable assets while addressing the common nonprofit purpose or objective that may be found on a national or multi-jurisdictional basis. Such an organization can be based on one of two models: the national association model or the centralized chapter model.

### *National Association Model*

The national association model involves multiple legal entities that are organized at various levels, such as incorporated provincial associations or incorporated local organizations. The national association model will have a governing body, normally established as a federal corporation, to act as the umbrella body over its member organizations, whether those members are corporations or unincorporated associations. A member organization will normally have either a name or nonprofit purpose that is similar to that of the governing national association.

The primary benefit of utilizing the national association model is that of reduced liability exposure for the organization by containing the liability attributable to each member organization within a separate corporate entity. As such, the claims made against a member organization do not necessarily affect the assets of other member organizations or that of the governing body.

The most obvious problem with the national association model is that a governing body can easily lose control over its separately incorporated member organizations if appropriate steps are not implemented to ensure that the member organizations are subject to appropriate contractual and/or licensing control mechanisms. In this regard, the national organization can lose goodwill and such intangible assets as trademarks through the actions of the local member.

### *Centralized Chapter Model*

The centralized chapter model involves one legal entity acting as a single nonprofit organization across Canada, normally involving

multiple divisions at either the provincial, regional, or local level, as is the case with the Canadian Cancer Society. Those divisions are often referred to as chapters or branches. However, none of the chapters or branches are themselves separate legal entities. Instead, the chapters or branches are a part of a single legal entity.

The most significant benefit of the centralized chapter model is that by requiring only one corporation, it is much easier to maintain a higher degree of control over chapters or branches without the necessity of contract or licence agreements that are otherwise required with the national association model. In addition, by utilizing only one corporation to carry on operations on a national basis, there is generally more symmetry and coherency to day-to-day operations and control of personnel. This model also avoids the risk of losing its assets, goodwill, donor base, or trademarks to a "renegade" member organization, since everything is legally owned by the single national corporation. A chapter or branch would have no legal right to take any assets on its own if it were to leave the national organization.

The most fundamental problem inherent in the centralized chapter model is that by having only one corporation, the liabilities that occur in the operations of one chapter will expose all of the assets of the national organization to claims arising out of activities of that one chapter even though other chapters may have had nothing to do with the incident in question. Similarly, even if the incident involves a national program involving all chapters, there is no ability to protect specific assets of the national organization, since all assets are owned by the national organization.

### *Association Agreements*

An association agreement is often referred to as a "chapter agreement", an "affiliation agreement", or a "membership agreement". The content of the agreement, not the terminology used to describe it, is what is important. The agreement sets out the contractual relationship between the governing association and its member organizations. Some of the more important considerations include:

- a recognition that despite the similar purposes, the two organizations are recognized at law as being separate and distinct corporate entities with separate boards of directors and that they are to remain independently responsible for the management and governance of their respective operations;

- an indication that the contractual relationship contained in the agreement does not constitute either a partnership or a joint venture arrangement between the parties;
- the term of the agreement;
- the basic requirements of the association relationship;
- the rights that flow from the association relationship;
- the actions by the member organization that would terminate the association relationship and the consequences that flow from termination;
- a mechanism for indemnification;
- the maintainance of documents, books, and records;
- provisions requiring compliance with various statutory obligations (*i.e*., tax laws, anti-terrorism legislation, *etc*.); and
- a mechanism for conflict resolution.

## REGISTERED CHARITIES UNDER THE INCOME TAX ACT

### Types of Registered Charities

As discussed above, there is an important distinction between nonprofit organizations and registered charities in Canada. The definition in the ITA of a nonprofit organization is a negative one in the sense that a nonprofit organization is one that is *not* a charity within the meaning of section 149.1(1) of the ITA.[51] If an organization has charitable purposes, it must be a charity and should seek registration under the ITA. Next, a charitable nonprofit organization has to determine what type of registered charity will best suit its objectives:

1. a charitable organization;
2. a public foundation; or
3. a private foundation.

Amendments to the ITA seem to be blurring the distinction between the types of registered charities, particularly between a charitable organization and a public foundation (see, *e.g.*, Man & Carter (2005a;

[51] ITA, s. 149(1)(*l*).

2005b)).[52] Nevertheless, the choice of charitable structure is important because it will determine which rules in the ITA will apply. The following general discussion of the differences between the types of registered charities will be followed by a more detailed summary of the specific rules affecting registered charities.

### *Charitable Organization*

Under the ITA, a charitable organization is one which devotes all of its resources to charitable activities carried on by the organization itself[53] — it is generally considered to be a "doing" organization. A charitable organization may be established as a corporation, an unincorporated association, or a trust. It cannot be controlled by a group of related directors/trustees,[54] and, like a nonprofit organization and the other types of registered charities, no part of its income may be payable to or otherwise available for the personal benefit of a proprietor, member, shareholder, trustee, or settlor.

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[52] The former Bill C-10 proposed amendments to the ITA that would have impacted the operations of registered charities in Canada in a substantial way, including the definition of "gift", split-receipting, designation of charitable organizations and public foundations, revocation of charitable registrations, *etc*. Bill C-10 was under review until September 7, 2008, when it died on the Order Paper as a result of the dissolution of Parliament and has not since been re-introduced but is expected to be in the near future. CRA is applying most of the amendments as if they are in force.

[53] The definition of "charitable organization" in s. 149.1(*l*) provides as follows:

> "charitable organization" means an organization, whether or not incorporated,
>
> (a) all the resources of which are devoted to charitable activities carried on by the organization itself,
>
> (b) no part of the income of which is payable to, or is otherwise available for, the personal benefit of any proprietor, member, shareholder, trustee or settlor thereof,
>
> (c) more than 50% of the directors, trustees, officers or like officials of which deal with each other and with each of the other directors, trustees, officers or officials at arm's length, and
>
> (d) … not more than 50% of the capital of which has been contributed or otherwise paid into the organization by one person or members of a group of persons who do not deal with each other at arm's length and, for the purpose of this paragraph, a reference to any person or to members of a group does not include a reference to Her Majesty in right of Canada or a province, a municipality, another registered charity that is not a private foundation, or any club, society or association described in paragraph 149(1)(*l*).

[54] The details of this requirement are discussed below.

### *Charitable Foundation*

The ITA provides that a charitable foundation is an entity which is created and operated exclusively for charitable purposes,[55] which may be either a public foundation or a private foundation. While they may carry on a limited number of charitable activities, charitable foundations generally provide funds to other charitable organizations or "qualified donees" so that those organizations may carry out their charitable activities. In this regard, charitable foundations are commonly considered "spending" or "funding" organizations. A charitable foundation may be established as either a corporation or a trust, but not an unincorporated association.

There are two types of charitable foundations: a public foundation and a private foundation. Like a charitable organization, a public foundation cannot be controlled by a group of related directors/trustees. A private foundation is defined in the ITA as simply a foundation which is not a public foundation. Generally, a private foundation is an entity established for philanthropic and/or tax planning purposes by a wealthy family or corporation which may be controlled by them.

## Specific Rules Affecting Registered Charities

### *Relationship between Directors/Trustees and Control*

Apart from the distinctions based on the difference between "doing" and "funding" entities, the most important requirement distinguishing a charitable organization and public foundation from a private foundation is the relationship between the directors/trustees and control of the entities. The ITA currently provides that more than 50 per cent of the directors or trustees of charitable organizations and public foundations must deal with each other and with each of the other directors or

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[55] The definition of "charitable foundation" in s. 149.1(1) is as follows: "'charitable foundation' means a corporation or trust that is constituted and operated exclusively for charitable purposes, no part of the income of which is payable to, or is otherwise available for, the personal benefit of any proprietor, member, shareholder, trustee or settlor thereof, and that is not a charitable organization".

trustees at arm's length.[56] The ITA also currently requires (although not applied from an administrative standpoint) that not more than 50 per cent of the capital contributed or otherwise paid to a charitable organization or public foundation be contributed by one person or members of a group of such persons who do not deal with each other at arm's length, save and except some organizations, *i.e.*, the federal government, provincial governments, municipalities, other registered charities that are not private foundations, and nonprofit organizations. This is usually referred to as the "contribution" test.

As a result of inquiries from the public, the Department of Finance proposed to amend[57] the definition of both "charitable organizations" and "public foundation" in order to ensure that in certain circumstances large donations are not prohibited by replacing the "contribution test" with a "control test" in section 149.1(1) of the Act, whereby it would be permissible for a person, or a group of persons not dealing with each other at arm's length, to contribute more than 50 per cent of the charity's capital as long as such a person or group does not control the charity in any way or represent more than 50 per cent of the directors, trustees, officers, and similar officials of the charity. The rationale for amending the definitions was to permit charitable organizations and public foundations to receive large gifts from donors without concern that they may be deemed to be private foundations by virtue of such gifts.

As a result of the likely introduction of a "control" test, the convoluted rules under the Act in relation to "control" are currently administratively applicable, specifically due to the inclusion of the phrase "controlled directly or indirectly in any manner whatever" in the new definitions.[58] However, the practical application of the rules

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[56] Section 251(1) provides that related persons do not deal at arm's length with each other and s. 251(2) provides that persons may be related by blood, marriage or adoption. There are also detailed rules in ss. 251 (am. S.C. 1994, c. 7, Sch. II, s. 195; S.C. 1998, c. 19, s. 242; S.C. 2000, c. 12, ss. 140, 142; S.C. 2001, c. 17, s. 192), and 256 (am. S.C. 1994, c. 7, Sch. II, s. 198; S.C. 1994, c. 21, s. 114; S.C. 1995, c. 3, s. 55; S.C. 1995, c. 21, s. 44; S.C. 1998, c. 19, s. 246; S.C. 2001, c. 17, ss. 194, 231; S.C. 2005, c. 19, s. 55), dealing with factual non-arm's length and factual control which are relevant for determining whether corporations deal at arm's length with individuals or other corporations, but are beyond the scope of this text.

[57] These amendments were first introduced as part of Draft Technical Amendments to the Act released on December 20, 2002. After a series of changes and revisions, the proposed amendments were reintroduced in Bill C-10 which was under review until it died on the Order Paper on September 7, 2008, as a result of the dissolution of the Parliament. These amendments have not been re-introduced in Parliament for enactment. However, if re-introduced and enacted, these amendments would become generally retroactive to January 1, 2000.

[58] Section 256(5.1) provides as follows:

concerning "control" in the charitable context is unclear, since these rules are premised upon application to commercial arrangements in a business context rather than for registered charities. (See Couzin (2005); Loukidelis (2004)). As such, directors and officers of registered charities will need to carefully review these rules when establishing charitable organizations and public foundations involving a major donor or when receiving a donation from a major donor who contributes more than 50 per cent of the capital of a charity in order to ensure that the charity in question will not inadvertently be caught by these rules and be designated a private foundation. As well, the current relationships between entities in multiple corporate structures should also be reviewed in order to assess whether this new control test may have an undesirable effect.

### *Disbursement Quota Rules*

All registered charities are required to annually expend a portion of their assets in accordance with a disbursement quota ("DQ"), which is a prescribed amount that registered charities must disburse each year in order to maintain their charitable registration. The purpose of the DQ is "to ensure that most of a charity's funds are used to further its charitable purposes and activities; to discourage charities from accumulating excessive funds; and to keep other expenses at a reasonable level".[59] New DQ rules were enacted in Bill C-33 on May 13, 2005,[60] and apply generally to taxation years beginning after March 22, 2004, except that, for charitable organizations registered before March 23, 2004, the 3.5 per cent DQ only applies to their taxation years beginning after 2008. Prior to Bill C-33, the DQ rules for charitable organizations and public foundations were significantly different. However, the new DQ rules contained in Bill C-33 generally apply to registered charities retroactively to March 23, 2004, such that the DQ rules for charitable organizations and public foundations are now the same, subject to some transitional provisions.

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> For the purposes of this Act, where the expression "controlled, directly or indirectly in any manner whatever," is used, a corporation shall be considered to be so controlled by another corporation, person or group of persons (in this subsection referred to as the "controller") at any time where, at that time, the controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation ...

[59] See Information Circular RC 4108, *Registered Charities and the Income Tax Act*, updated May 7, 2002, and available online at: <http://www.cra-arc.gc.ca/E/pub/tg/rc4108/rc4108-02e.pdf>.

[60] The *Budget Implementation Act, 2004, No. 2*, S.C. 2005, c. 19 (Bill C-33).

The new rules are too complex to detail here,[61] but the calculation of the DQ occurs in accordance with a complicated formula consisting of two parts: the 80 per cent disbursement requirement aimed at limiting administrative expenses and the 3.5 per cent requirement aimed at preventing accumulation of funds. The main features of the new DQ for charitable organizations and public foundations may be summarized as follows:

The 80 per cent DQ is equal to (1) 80 per cent of gifts receipted in the immediately preceding year (except gifts of enduring property and gifts received from other registered charities), plus (2) 80 per cent of enduring property expended in the year and 100 per cent of enduring property transferred to qualified donees in the year, less the optional reduction by the amount of realized capital gains on enduring property, plus (3) 80 per cent of gifts received from other charities in the immediately preceding year (except property that was received as a specified gift or as enduring property). The primary concern for most organizations with respect to changes to this part of the DQ will be ensuring that it clearly identifies what may be considered enduring property in accordance with the new definition in section 149.1(1): gifts by way of bequest or inheritance; 10-year gifts; life insurance proceeds, registered retirement income funds, and registered retirement savings plans as a result of direct beneficiary designation; and gifts received by the charity as a transferee of an enduring property from either an original recipient charity or another transferee charity.

In addition to the 80 per cent DQ requirement, organizations will also be required to expend at least 3.5 per cent of their assets that are not used directly in its charitable activities or administration (commonly referred to as "investment assets"). The value of the assets in this regard is based on the average value of the charity's assets that are not used directly in its charitable activities or administration in the 24 months immediately preceding the taxation year.[62]

The DQ rules for private foundations are very similar to those for charitable organizations and public foundations, except that private foundations must expend 100 per cent (rather than 80 per cent) of all

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[61] Provided for in the definition of "disbursement quota" in s. 149.1(1) of the ITA. See Man & Hoffstein (2005). See also *Charity Law Bulletin* Nos. 59, 61, 67, and 69, available online at <http://www.charitylaw.ca>.

[62] The 3.5 per cent DQ does not apply if the amount of property owned by the charity in this regard is $25,000 or less. The detailed method for the calculation of the 3.5 per cent DQ is set out in ss. 3700, 3701, and 3702 of the *Income Tax Regulations*, C.R.C. 1978, c. 945 (am. SOR/87-632, s. 1; SOR/94-686, ss. 22(F), 51(F), 73(F), 79(F)).

amounts received from other registered charities in the immediately preceding taxation year, other than specified gifts and enduring property.

### *Related Business*

Charitable organizations[63] and public foundations can carry on related businesses.[64] If charitable organizations and public foundations carry on *un*related businesses, their charitable status may be revoked.[65] Private foundations, however, may not carry on any business activity, otherwise their charitable status may be revoked.[66]

### *Charitable Activities*

As noted above, charitable organizations primarily carry on their own charitable activities. They may give funds to other qualified donees but may not disburse more than 50 per cent of their income annually to qualified donees,[67] unless the qualified donees are also associated charities.[68] Public foundations, however, are required by CRA to give more than 50 per cent of their income annually to other qualified donees. This requirement is not explicitly set out in the Act, but implied by

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63 Paragraph 149.1(6)(*a*) of the ITA.

64 See Canada Revenue Agency Policy Statement CPS-019 entitled "What is a Related Business?" dated March 31, 2003, for a discussion of what CRA considers to be a related business, available online at: <http://www.cra-arc.gc.ca/tax/charities/policy/cps/cps-019-e.html>. See also *Alberta Institute on Mental Retardation v. Canada*, [1987] F.C.J. No. 286, [1987] 3 F.C. 286 (F.C.A.) and *Earth Fund v. Canada (Minister of National Revenue)*, [2002] F.C.J. No. 1769 (F.C.A.).

65 Paragraphs 149.1(2)(*a*) and 149.1(3)(*a*) of the ITA.

66 Paragraph 149.1(4)(*a*) of the ITA.

67 Paragraph 149.1(6)(*b*) of the ITA. Section 149.1(1) of the ITA provides that qualified donees are organizations that can issue official donation receipts for gifts that individuals and corporations make to them under ss. 110.1(1)(*a*) and (*b*) and 118.1(1). These consist of registered charities in Canada, registered Canadian amateur athletic associations; housing corporations resident in Canada constituted exclusively to provide low-cost housing for the aged; Canadian municipalities; the United Nations and its agencies; universities that are outside Canada that are prescribed to be universities the student body of which ordinarily includes students from Canada; charitable organizations outside Canada to which Her Majesty in right of Canada has made a gift during the fiscal period or in the 12 months immediately preceding the period; and Her Majesty in right of Canada or a province. In July 2005, it was proposed to amend ss. 110.1 (am. S.C. 1994, c. 7, Sch. II, s. 79; S.C. 1994, c. 7, Sch. VIII, s. 46; S.C. 1996, c. 21, s. 20; S.C. 1997, c. 25, s. 22; S.C. 1998, c. 19, s. 20; S.C. 2001, c. 17, s. 85; S.C. 2005, c. 19, s. 19) and 118.1 (am. S.C. 1994, c. 7, Sch. II, s. 88; S.C. 1994, c. 7, Sch. VIII, s. 53; S.C. 1995, c. 3, s. 34; S.C. 1995, c. 38, s. 3; S.C. 1996, c. 21, s. 23; S.C. 1997, c. 25, s. 26; S.C. 1998, c. 19, s. 22; S.C. 1999, c. 22, s. 32; S.C. 1999, c. 31, s. 136; S.C. 2001, c. 17, s. 94; S.C. 2005, c. 19, s. 23) of the Act by expanding the list of qualified donees to include municipal or public bodies performing a function of government in Canada.

68 Paragraph 149.1(6)(*c*) of the ITA.

virtue of the requirement in section 149.1(6)(*b*) of the ITA that charitable organizations may not disburse more than 50 per cent of their income annually to qualified donees and the definition of "charitable foundation" in section 149.1(1) of the ITA, which provides that a charitable foundation is "not a charitable organization" (Man & Carter (2005b)).

Private foundations may carry on their own charitable activities, and may give funds to other qualified donees. It is not clear from the Act whether there is any requirement on private foundations to give more than 50 per cent of their income annually to other qualified donees. As explained above, CRA takes the administrative position that the language in the definition for "charitable foundation" implies that public foundations must disburse at least 50 per cent of their income to qualified donees. CRA also takes the administrative position that since the definition of "private foundation" in section 149.1(1) of the ITA provides that a private foundation is a charitable foundation that is *not* a public foundation, private foundations are not required to give at least 50 per cent of their income annually to other qualified donees.

### *Borrowing*

Public and private foundations are prohibited from incurring debts other than debts for current operating expenses, the purchase and sale of investments or the administration of the charitable activities.[69] These restrictions do not apply to charitable organizations.

### *Control of Other Corporations*

Public and private foundations are prohibited from acquiring control of any corporation.[70] Failure to comply with this restriction may lead to revocation of a foundation's registration. Generally, control occurs when the foundation owns 50 per cent or more of a corporation's issued share capital, having full voting rights under all circumstances. However, a foundation that has not purchased more than 5 per cent of these shares but is given a block of shares that brings up its total

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[69] Paragraphs 149.1(3)(*d*) and 149.1(4)(*d*) of the ITA.

[70] Paragraphs 149.1(3)(*c*) and 149.1(4)(*c*) of the ITA.

holding to more than 50 per cent will not be considered to have acquired control of the corporation.[71]

The restrictions that apply to foundations do not apply to charitable organizations. This means that, for purposes of the Act, charitable organizations are permitted to acquire control of a corporation. As such, CRA suggests that a charitable organization may operate a business through a taxable share capital corporation with the charitable organization retaining control over the taxable corporation "through share holdings or a power to nominate the board of directors".[72] However, this option is not available to charities in Ontario as a result of the application of the Ontario *Charitable Gifts Act*.[73]

The following table summarizes some of the specific rules affecting registered charities, including recently enacted amendments and proposed amendments (Man & Carter (2005a)).

**Table 1: Rules affecting Registered Charities**

| Characteristics | Types of Registered Charities | | |
|---|---|---|---|
| | Charitable Organizations | Public Foundations | Private Foundations |
| (1) Relationship between directors/ trustees and control | Currently, more than 50% of the directors of charitable organizations and public foundations must deal with each other and with each of the other directors or trustees at arm's length. Further, not more than 50% of the capital contributed or otherwise paid to a charitable organization or public foundation can be contributed by one person or members of a group of such persons who do not deal with each other at arm's length (except some organizations, *i.e.*, the federal government, a provincial government, a municipality, other registered charities that are not private foundations, and non-profit organizations). This is usually referred to as the "contribution" test. | | No requirements — may be closely held. |

71 *Ibid*.

72 See CRA Policy Statement CPS-019 entitled "What is a Related Business?" dated March 31, 2003 at paras. 47 and 48, available online at: <http://www.cra-arc.gc.ca/tax/charities/policy/cps/cps-019-e.html>.

73 Section 2(1) of the *Charitable Gifts Act*, R.S.O. 1990, c. C.8, provides that a charity is not permitted to own more than ten per cent (10%) of an "interest in a business that is carried on for gain or profit is given to or vested in a person in any capacity for any religious, charitable, educational or public purpose". A charity, however, is permitted to invest in a business as a minority owner, provided that it does not "own", either directly or indirectly, an interest in excess of 10 per cent. If the charity is found to own more than 10 per cent of an interest of a business, it would have to dispose of any interest in excess of 10 per cent within seven years, although it might be possible to obtain a court order to extend the seven-year period.

| Characteristics | Types of Registered Charities | | |
|---|---|---|---|
| | Charitable Organizations | Public Foundations | Private Foundations |
| | Proposed amendments would have replaced the "contribution test" with a "control test", such that a person or a group of persons not dealing with each other at arm's length may contribute more than 50% of the charity's capital as long as such a person or group does not control the charity in any way or represent more than 50% of the directors, trustees, officers and similar officials of the charity (amendment retroactive to January 1, 2000). | | |
| (2) Disbursement quota rules | The disbursement quota rules for charitable organizations and public foundations are now the same, subject to a transitional period for charitable organizations registered before March 23, 2004, in that the 3.5% disbursement quota will apply to their taxation years that begin after 2008. To summarize:<br>• 80% disbursement quota: generally 80% of gifts receipted in the immediately preceding year (except gifts of enduring property)<br>• 3.5% disbursement quota: 3.5% of investment assets with possible encroachment on capital gains to satisfy the 3.5% disbursement quota | | The disbursement quota rules for private foundations are very similar except that private foundations must expend 100% (rather then 80%) of all amounts received from other registered charities in the immediately preceding taxation year (other than specified gifts and enduring property). |
| (3) Related business | Can only carry on related businesses | | Cannot carry on any business |
| (4) Charitable activities | Primarily carry on their own charitable activities, may give funds to other qualified donees, may not disburse more than 50% of their income annually to qualified donees, unless they are associated charities. | Public foundations must give more than 50% of their income annually to other qualified donees. | Private foundations primarily fund other charities. |
| (5) Legal structure | Must either be corporations, unincorporated associations or charitable trusts. | Must be either corporations or trusts. | |
| (6) Borrowing | No restriction. | Cannot incur debts other than debts for current operating expenses, the purchase and sale of investments, or the administration of the chartable activities. | |

| Characteristics | Types of Registered Charities | | |
|---|---|---|---|
| | Charitable Organizations | Public Foundations | Private Foundations |
| (7) Control of other corporations | No restriction. | Cannot acquire control of any corporation. Generally, control occurs when the foundation owns 50% or more of a corporation's issued share capital, having full voting rights under all circumstances. There is an exception where a foundation has not bought more than 5% of these shares and is given a bloc of shares that brings up its total holding to more than 50%, it will not be considered to have acquired control of the corporation. | |

## New Regulatory Regime

In addition to changes to the DQ, Bill C-33 introduced a new regulatory regime for registered charities. The amendments implement new rules concerning the taxation and administration of charities, including new intermediate sanctions and a more accessible appeals regime. These changes provide more appropriate recourse for unintended or incidental breaches and are therefore important for charities.

### *Interim Sanctions*

Prior to the 2004 Federal Budget, the only sanction available to CRA in regulating registered charities was the revocation of a charity's registration (Canada, Department of Finance (2004, at p. 338)). Revocation occurred sometimes inadvertently as a result of a failure by the charity to file an information return or because the charity was being discontinued, and was only invoked rarely by CRA in situations of serious non-compliance and only after a lengthy audit process. To provide an alternative to the revocation of charitable status for minor or unintended infractions, the ITA now provides for intermediate sanctions.[74] In the situation of a failure to file an information return on time, the registered charity will be subject to a monetary penalty of $500. A registered charity may also face a suspension of its ability to issue tax receipts and to receive funds from other charities for one year if it fails to comply with certain verification and enforcement provisions of the Act (*e.g.*, fails to keep proper books and records). Private foundations, public foundations and charitable organizations which carry on certain business

[74] For a complete list of sanctions, see "Penalty Chart" in Canada Revenue Agency, Policy Statement CSP-S18, available online at: CRA <http://www.cra-arc.gc.ca/tx/chrts/plcy/csp/pnlts-eng.html>.

activities will be subject to a monetary penalty equal to 5 per cent of their gross revenue from such business activities and a repeat offence within five years of the first infraction will carry a monetary penalty equal to all of the charity's gross revenue from the offending activities as well as a suspension of its ability to issue tax receipts.

Similarly graduated monetary penalties will be applied to registered charities if:

- a charitable foundation acquires control of a corporation;
- a registered charity confers on a person an undue benefit (essentially, transfers resources of the charity for the personal benefit of a member, director or trustee of the charity which could include excessive salaries or board compensation);
- a registered charity issues improper receipts;
- a person provides false information for the purposes of a tax receipt, which could include incorrect valuation information of either the property gifted or the advantage received by the donor when making the donation; or if
- a registered charity makes a transfer to another registered charity for the purpose of delaying expenditures on charitable activities.

In addition, if a charitable foundation acquires control of a corporation a second time within the span of five years, if false information has been provided and the amount of the penalty imposed is in excess of $250,000, or if a charity has received a gift and issued a receipt on behalf of a registered charity under suspension, the registered charity will also face suspension of its ability to issue tax receipts and to receive funds from other charities for one year.[75]

### *Appeals Process*

The appeals regime is intended to make the appeal process more accessible and affordable for registered charities and unsuccessful applicants for charitable status. Previously, the only avenue for challenging CRA's decisions on charitable matters was through the Federal Court of Appeal. The amendments have extended CRA's existing internal objection review process to notices of a decision by CRA regarding the revocation or annulment of a charity's registration,

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[75] The interim sanctions generally provided in section 188.1 of the ITA.

the designation of a charity as a private or public foundation or a charitable organization, the denial of applications for charitable status, suspension of tax-receipting privileges, and the imposition of monetary penalties or revocation tax against a registered charity. Filing a notice of objection is a required step before an appeal may be brought to the courts.

If a charity disagrees with CRA's decision resulting from an objection, appeals in respect of decisions concerning refusals to grant registered charitable status and revocation of registered charitable status will continue to be made to the Federal Court of Appeal. However, with respect to the imposition of the monetary penalties and/or the revocation tax or suspension of its tax receipting privileges, a charity may appeal the decision to the Tax Court of Canada under either the informal procedure (expected to apply if the amount of penalties or tax is less than $12,000) or general procedure.

### *Fundraising Policy*

CRA released a new fundraising policy in June 2009 which will significantly impact the parameters within which charities can carry on fundraising activities.[76] The policy explains how to distinguish between fundraising and charitable activities. It also provides guidance concerning the amount of expenses that may be expended on fundraising activities compared to the resulting revenue from such fundraising endeavours. Finally, the policy provides guidance concerning factors, both positive and negative, in considering the appropriateness of fundraising activities carried on by charities.

## RISK MANAGEMENT AND LIABILITY

The operations of charities and nonprofits have become complex and the possibility of litigation against them occurring as a result of their operations is greater than ever before. The exposure of charities and nonprofits to liability goes further than the loss of assets and/or the insolvency or winding up of a charity or nonprofit. Directors may also personally face legal actions against themselves by donors, members, third parties, and governmental authorities for breach of their fiduciary duties or even breach of trust in failing to adequately protect or apply

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[76] See CPS-028, Guidance on Fundraising by Registered Charities, effective June 11, 2009, available online at: <http://www.cra-arc.gc.ca/tx/chrts/plcy/cps/cps-028-eng.html>.

the assets of a charity or nonprofit. Given these increases, there is a greater need to protect assets from lawsuits and creditors on a pro-active basis.

*Black's Law Dictionary* defines "risk" as the "chance of injury, damage or loss", and it defines "risk management" as the "procedures or systems used to minimize accidental losses".[77] Although the levels of risk are subjective and difficult to quantify for such a diverse sector as the nonprofit sector in Canada, it is important for directors and members to understand the impact of risk on the operation of their organizations. As most directors and managers already understand, risk cannot be completely eliminated, but it can be managed through conscientious and careful planning and organization. Liability and risk management must be reviewed from many different standpoints, including from the level of the organization or corporation and from the level of directors and officers.

## Level of the Organization/Corporation

### *Choice of Nonprofit or Charitable Structure*

As was discussed above in the section "Legal Structure for Nonprofit Organizations", the choice of the appropriate nonprofit or charitable structure is a primary consideration for managing risk and liability. Depending on the choice of legal structure, risk and liability will rest with different parties. For instance, an unincorporated association has no legal capacity to sue, be sued, or to contract, and only derives its existence from its members. As such, the unincorporated association can bear no liability for the acts or omissions of its members; instead it is the individual members who will ultimately be liable (Bourgeois (2008, at p. 228)). Like the unincorporated association, a trust has no legal personality. Thus, all actions are carried out by the trustee, who must bear the liability for any acts or omissions. However, the trustee acting in accordance with its obligations and authority as trustee is entitled to be reimbursed for reasonable expenses, so the trust and/or the beneficiaries may ultimately bear the financial liability for any claim (Waters (2005)). An incorporated corporation without share capital, on the other hand, *is* a separate legal entity from that of its members, and therefore has the legal capacity to sue, to be sued, and to contract with other parties. With legal capacity, the incorporated

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[77] *Black's Law Dictionary* (1999), *s.v.* "risk" and "risk management".

corporation without share capital bears the liability for breach of contract, negligence, or other suable actions of its directors, officers, members, staff, volunteers, and agents.

### *Standard of Care*

The standard of care is a legal concept referring to the degree of care expected of an individual in relation to a duty to other individuals. An individual will only incur liability where his or her conduct falls below that which is expected by the community. Texts and case law generally do not discuss the standard of care expected of a business corporation, let alone a nonprofit corporation. As such, any discussion of standard of care will generally relate to that which is expected of directors and officers. This is likely because the corporation is a fictionalized person while a trust or unincorporated association has trustees and members standing in front of them. Conceptually, it is difficult to apply a standard of care to a fictional person, but the courts will hold a corporation both directly and vicariously liable for the acts or omissions of its directors, officers, staff, and volunteers. In assessing liability against a corporation, the court will apply the "reasonable person" standard; that is, whether the corporation acted in the same manner as a reasonably careful person in the circumstances (Osborne (2003)). For example, a court (and therefore an effective risk manager) would ask: "Did the nonprofit corporation exercise reasonable care in training its staff?"

### *Vicarious Liability (Directors, Officers, Staff, Volunteers)*

Vicarious liability imposes liability upon an employer or principal for the conduct of an employee or agent, on the grounds that the employer or principal should be held accountable for losses to third parties that arise from the actions of the employee or agent. Unlike the principle of personal liability, vicarious liability does not require that the employer or principal actually cause the loss sustained by the third party. Liability is imposed on the employer or principal with the rationale that the loss is the result of a reasonably foreseeable risk and attributable to the employer's or principal's activities, and that it is reasonable that the employer or principal should be liable for the risk.

From a public policy point of view, vicarious liability is designed to ensure that parties undertaking risky enterprises take all reasonable measures to reduce the risk. It is a form of risk allocation, in keeping

with the logic behind tort law in Canada; namely, losses will be suffered in our modern world, and we should be aware of the losses we cause, and should try to reduce the risks of such losses, or compensate for them when appropriate.

In the seminal case of *Bazley v. Curry*,[78] the Supreme Court of Canada provided a two-part approach for determining whether and when vicarious liability should be imposed on an employer.[79] First, a court should determine whether there are precedents which unambiguously determine whether vicarious liability should be imposed under the circumstances in the case. Second, "[i]f prior cases do not clearly suggest a solution, the next step is to determine whether vicarious liability should be imposed in light of the broader policy rationales behind strict liability."

In general, vicarious liability will be imposed by the courts where the plaintiff can establish the following: (1) the relationship between the tortfeasor (*i.e.*, the employee) and the person against whom liability is sought (*i.e.*, the employer) is sufficiently close; and (2) the wrongful act was sufficiently connected to the conduct authorized by the employer. To determine whether a sufficient connection exists under part 2 of the test referred to above, the Supreme Court of Canada has set out some factors to consider:

- the extent to which the wrongful conduct may have furthered the employer's enterprise;
- the extent to which the wrongful act was related to friction, confrontation or intimacy inherent in the employer's enterprise;
- the opportunity that the enterprise of the employer or principal affords to the employee or agent to abuse his or her power;
- the extent of power conferred on the employee in relation to the victim; and
- the vulnerability of potential victims to wrongful exercise of the employee's power.[80]

Recent case law has affirmed that charities and nonprofit organizations can be held vicariously liable for the conduct of their employees and agents, and they do not enjoy any special "immunity" on

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78 [1999] S.C.J. No. 35, [1999] 2 S.C.R. 534 (S.C.C.) (hereinafter "Bazley").

79 *Ibid*., at para. 15. See also *Jacobi v. Griffiths*, [1999] 2 S.C.R. 570 at para. 31.

80 *Ibid*., at para. 41.

account of their nonprofit status.[81] As a result, charities and nonprofits have a significant obligation to carefully supervise and monitor the conduct of their employees, especially where those employees are in a position of power and authority over others. The importance of such supervision and implementation of risk management mechanisms — such as a policy against child abuse — cannot be understated.[82]

However, in addition to these due diligence steps, it is important for charities to assess and, if necessary, modify their organizational structure so that, in the event that a tort claim is successfully brought against the charity, liabilities may be contained and charitable property protected.[83]

### *Anti-terrorism Legislation Compliance*

A discussion of anti-terrorism legislation compliance may seem odd in a work about nonprofit organizations, yet they, with charities and non-governmental organizations ("NGOs"), have been identified as a "crucial weak point" (Financial Action Task Force (2002a)) in money laundering and terrorist financing initiatives in the international community, and are thus subjected to increasing scrutiny by government.[84] The fear remains that "non-profit organizations that engage in raising or disbursing funds for charitable, religious, cultural, educational, social or fraternal purposes, or for the carrying out of other types of 'good works' [will be] … misused or exploited by the financiers of terrorism".[85] In addition to sham organizations, the international community has witnessed instances where terrorist organizations were supported without the knowledge of the donor or directors of the organization.[86]

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81 See, *ibid.*, where the Supreme Court of Canada rejected the argument that nonprofit organizations should be shielded from tort liability in the public interest. See also *John Doe v. Bennett*, at para. 24, where the Supreme Court of Canada confirmed that nonprofit status in itself would not be sufficient grounds to obviate a finding of vicarious liability. For more information see Mervyn F. White, "Supreme Court of Canada Brings Clarity to Vicarious Liability of Churches in Canada" (2005), *Church Law Bulletin* No. 11, online at: <http://www.carters.ca/pub/bulletin/church/index.html>.

82 Carter (2008).

83 *Ibid*.

84 An important resource in this respect is <http://www.antiterrorismlaw.ca>. In particular, see, *e.g.*, Carter (2005).

85 Carter (2005).

86 See, *e.g.*, Financial Action Task Force, *Report on Money Laundering Typologies 2001-2002* (2002). The FATF Report provides a number of examples of activities that were found to be

Although nonprofit and charitable organizations were not the primary target of the far-reaching counterterrorism legislation that was introduced in Canada following the terror attacks on New York and Washington, D.C., on September 11, 2001, the organizations and directors of those organizations have much to fear should they become the unwitting assistants of terror organizations. Nonprofit organizations should be aware of some of the key pieces of legislation that were affected by Canada's *Anti-terrorism Act*,[87] including the *Criminal Code*[88] and the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*.[89] Of particular note in the *Criminal Code* amendments is the introduction of offences for "facilitating" a terrorist activity or organization.[90] Despite government claims to the contrary, these poorly drafted sections may ensnare otherwise innocent organizations that unknowingly assist terrorist organizations.

The *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* also places a heavy burden on organizations that deal in large financial transactions to retain detailed records and report information to the Financial Transactions & Reports Analysis Centre of Canada ("FINTRAC"). Failure to do so carries significant penalties and the possibility of seizure of funds.

These provisions highlight the need for due diligence on the part of the nonprofit organization. Not only should there be strict controls on the financial operations of the organization, but the operational side of the organization needs to be carefully managed. Policies demonstrating intent to comply with anti-terrorism legislation should be in place and nonprofit organizations should be able to document their administrative, managerial, and policy control over their operations. This necessarily includes auditing or investigating other organizations with which the nonprofit organization works, overseeing activities conducted, and accounting for funds expended.

Until recently, there was very little practical guidance for charities or nonprofit organizations with respect to compliance with anti-terrorism legislation and due diligence procedures. In April 2009, Canada Revenue Agency released Checklist for Charities on Avoiding

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in support of terrorist activities, whether it be providing financial assistance or providing shelter.

87 S.C. 2001, c. 41 (proclaimed in force December 24, 2001).

88 R.S.C. 1985, c. C-46.

89 S.C. 2001, c. 17.

90 See, *e.g.*, *Criminal Code*, R.S.C. 1985, c. C-46, at ss. 83.18, 83.19, 83.21 and 83.22 (all enacted 2001, c. 41, s. 4).

Terrorist Abuse (the "Checklist")[91] in order to provide guidance to Canadian registered charities in identifying vulnerabilities to terrorist abuse and develop good management practices. Though the Checklist falls short of providing comprehensive guidelines for compliance with Canada's complex body of anti-terrorism legislation, the Checklist is an important first step in assisting charities to develop due diligence procedures.

The full extent to which the government will enforce anti-terrorism provisions against unwitting organizations remains to be seen. However, a growing aspect of the federal government's anti-terrorism initiative is the designation of organizations to a list established under the terrorism provisions of the *Criminal Code*. Until now, the entities on this list have primarily included widely recognized foreign organizations, such as Hezbollah and Al-Qaeda. Nevertheless, for the first time since the list was established in 2002, a Canadian nonprofit organization, the World Tamil Movement, was added in June 2008 to the list of over 40 entities deemed to have facilitated or been associated with terrorist activities.[92]

As a further illustration of the government's enforcement of these anti-terrorism provisions, on March 14, 2008, the first person in Canada to be charged under Canada's anti-terrorism financing laws was arrested in New Westminster, British Columbia. The accused, a Toronto area resident, was charged with committing an offence under section 83.03(b) of the *Criminal Code* — the section that makes it an offence to provide, or make available property or services for terrorist purposes. It is alleged that the accused solicited donations in British Columbia for the World Tamil Movement (WTM), a humanitarian organization, which the police claim is the leading Liberation Tigers of Tamil Eelam ("LTTE") front organization in Canada.[93]

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91 Available online at: <http://www.cra-arc.gc.ca/tx/chrts/chcklsts/vtb-eng.html>.

92 Carter, S.S. (2008).

93 Carter, T.S. & S.S. Carter (2008).

## Level of Directors and Officers

### *Role and Duties of Directors and Officers*

The most basic role or duty of a director of a nonprofit organization is to manage the affairs of the corporation.[94] In essence, the directors are the guiding minds of the corporation, while the officers and staff manage the day-to-day operations. Managing the affairs of the corporation encompasses a broad spectrum of duties, including: ensuring the organization adheres to and carries out the goals of the corporation; setting long-term objectives in accordance with these goals; ensuring financing stability; assessing the corporation's performance; establishing policies; and being the public face of the corporation (Burke-Robertson & Drache (2002, at pp. 5-1 and 5-2)). Any or all of these duties may be limited by the organization's by-laws; however, the directors must always be able to demonstrate that they "manage the affairs" of the corporation in accordance with the governing legislation.

In managing the affairs of the corporation, a director has a number of fiduciary duties, including: a duty to act honestly; a duty of loyalty; a duty of diligence or to act in good faith; a duty to exercise power; a duty of obedience; a duty to avoid conflict of interest; a duty of prudence; and a duty to continue. Many of these duties are self-explanatory, but some comments are warranted. The duty to exercise power is essentially a requirement that the director fulfills his role, pursues the organization's objectives and does not fail to supervise delegated tasks. Similarly, the duty to continue requires a resigning director to ensure there is an adequate replacement. Resignation will not avoid liability and may constitute breach of fiduciary duty where the director put his or her own interests ahead of those of the corporation.

### *Liability of Directors and Officers*

As Burke-Robertson notes, although the applicable standard of care for directors of business corporations is statutorily defined, most jurisdictions do not provide the same for corporations without share capital (at p. 6-3). Only British Columbia, Newfoundland, Manitoba and

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[94] See, *e.g.*, *Corporations Act*, R.S.O. 1990, c. C.38, s. 283(1). A useful reference tool in this respect is a publication from Industry Canada, *Primer for Directors of Not-for-Profit Corporations (Rights, Duties and Practices)* (Ottawa: Industry Canada, 2002).

Saskatchewan have codified an objective standard of care (at p. 6-4).[95] In the absence of a codified standard of care, one must look to the common law, which has set the standard of care as "conduct that may reasonably be expected from a person of such knowledge and experience as the identified director".[96] This subjective standard of care means that a director who is, for example, a lawyer or business executive may be held to a higher standard of care than a director who is a factory worker. Although Bourgeois notes that the courts have historically been "reluctant to enforce the standard too rigorously in circumstances where, for example, the director was not involved in managing the affairs of the corporation" (Bourgeois (2002, at p. 223)), there has been a noticeable change in tide in the wake of the collapse of Enron and Worldcom.

Enhanced corporate governance is a popular slogan for both business corporations and nonprofit corporations. Good governance, which includes such principles as participation in decision-making; accountability and transparency; responsive, effective, and efficient performance; and sound rule of law, is the responsibility of the directors, who have the duty and power to manage the affairs of the corporation. In the absence of a limitation on liability for directors (which is available only in Saskatchewan), acting in good faith will not be sufficient to avoid liability. As such, directors who do not perform to the expected standard of care may be liable for the damages that result from their actions.

Additionally, both provincial and federal statutes impose liability on directors in specific circumstances. For example, directors of nonprofit corporations are jointly and severally liable to employees for unpaid wages to a maximum of six months.[97] On a related issue, they are liable for the corporation's failure to remit an employee's source deductions to the tax authorities, along with interest and penalties.[98] Directors will also be held liable for the corporation's failure to meet reporting, record-keeping, or filing requirements under various pieces

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[95] See *Society Act*, R.S.B.C. 1986, c. 433; *Corporations Act*, R.S.N.L. 1990, c. C-36; *Non-profit Corporations Act, 1995*, S.S. 1995, c. N-4.2; and *Corporations Act*, C.C.S.M., c. C225.

[96] At p. 6-4.1, referencing *In re City Equitable Fire Insurance Co*., [1924] All E.R. Rep. 485 (Eng. C.A.).

[97] See, *e.g.*, *Canada Corporations Act*, R.S.C. 1970, c. C-32, s. 99 (am. 2004, c. 25, s. 189); Ontario *Corporations Act*, R.S.O. 1990, c. C.38, s. 81 (am. 1992, c. 32, s. 6(6); 2002, c. 24, Sch. B, s. 31).

[98] ITA, s. 227.1(1).

of legislation.[99] As such, directors are subject to both pecuniary and criminal liabilities.[100]

### *Rights and Powers*

It goes without saying that directors would be unable to effectively carry out their duties without concomitant rights and powers. Given the heavy burden directors carry with respect to liability for their actions and the actions of the corporation, directors have a right to unimpaired access to all resources of the corporation in order to effectively perform their duties. This necessarily requires access to books and records, notice of meetings, an equal right to vote at the meetings, and a right to inspect and approve or disapprove the minutes of previous meetings of the board.

Like the director's rights, the powers complement their duties. In this respect, directors have the power to manage the affairs of the corporation, the power to borrow money in accordance with statutory procedures, the power to make investments on behalf of the corporation and the power to dispose of property.

### *Statutory Protection*

Unlike their business counterparts, there is little in the way of statutory protection for directors of nonprofit organizations. In fact, the CCA only provides two forms of statutory protection. First, in respect of contracts with third parties, directors will not be liable to those parties so long as they are acting within the scope of their authority as agents of the corporation (Carter (2002, at p. 74)). The second statutory protection deals with conflicts of interest. There is a common law rule prohibiting directors of nonprofit organizations from profiting or benefiting directly or indirectly from their position. Should any benefit accrue, the director would be in breach of his or her fiduciary duty and would be held accountable to the organization for the benefits

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[99] See, *e.g.*, CCA, s. 114.2(5) (am. 1985, c. 26, s. 36); or ITA, s. 238.

[100] Although there are no statistics on the number of directors that have had pecuniary and criminal liabilities imposed upon them, there are some interesting examples. In *Ontario (Public Guardian and Trustee) v. National Society for Abused Women and Children*, [2002] O.J. No. 607 (Ont. S.C.J.), the three directors of the charitable organization were ordered to repay the nearly $1 million they funneled into non-arm's length fundraising corporations and were prohibited from acting as directors of any other charitable organization until the funds had been repaid. Noting that only $1,365 of the nearly $1 million raised made its way to charitable work, the court stated: "A distinct odour emanates from the facts of this case."

received. This translates into a practice of avoiding conflicts of interest or even the appearance of a conflict of interest. However, the CCA enables a director to avoid liability for receiving a benefit if the director declares his or her conflict of interest and abstains from any discussion or vote on the matter (Carter (2002, at p. 74)).

## Other Means of Reducing Risks

### *Indemnification, Insurance, and Risk Transfer*[101]

Indemnification and insurance are key considerations for both the nonprofit organization and any individual considering being a director. Indemnification is the process by which the corporation agrees to cover the cost of, or compensate the director for, any loss or damage sustained as a result of the acts or omissions of the director in his capacity as a director of the organization.[102] Of course, this would not cover illegal acts or omissions, or directors who are in breach of their fiduciary duty. In order for a nonprofit corporation to provide indemnity for its directors, such a power must be included in the organization's by-laws. This provides a measure of protection for the director, thereby enabling the organization to attract capable individuals to the position. It may also be prudent for individuals who consider becoming a corporate director (whether it be for a for-profit corporation or a nonprofit corporation) to obtain personal indemnity agreements from the corporation. This agreement will increase a director's likelihood of avoiding personal responsibility for the legal costs associated with possible claims arising from his or her responsibilities as a director.[103] However, such an indemnity is worthless if the organization does not have sufficient assets to cover significant claims, which is likely the case if there is a sexual abuse claim.

Insurance, on the other hand, could prove to be an important safety net if the nonprofit corporation is involved in risky operations which could result in significant claims made against the organization and its directors. There are a variety of types of insurance an organization should consider obtaining, depending on the size and type of its activities. In addition to general liability insurance, directors and officers liability insurance ("D&O") is one type that is appropriate for all nonprofit organizations, as it provides protection in relation to the

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[101] For a useful resource in this respect, see Carter & Demczur (2008).

[102] *Black's Law Dictionary* (1999), *s.v.* "indemnification" and "indemnify".

[103] See Oh (2009).

board's acts or omissions, and any activities conducted under the auspices of the board of directors.

Regardless of the type of insurance obtained, directors should review the policies in order to determine any limitations. These limitations may be in the form of the type of activity covered, the number of claims permitted in a time period, or the timeframe in which an action will be covered (*i.e.*, whether the policy will provide coverage in 2005 for an incident that occurred in 1995, or if a policy purchased in 2005 will cover any claims made in 2015 as a result of incidents occurring in 2005).

Another method of reducing risk that should be considered is risk transfer. In some cases, charities and nonprofit organizations may want to develop and administer effective liability shields in the form of informed consents, disclaimers, releases, waivers, and indemnities for program participants as necessary. In this regard, liability risk can be transferred from the organization and its directors to program participants.

### *Due Diligence in Operations (Maintaining the Corporation)*

Exercising due diligence is the most effective way for directors to protect themselves from liability. The Directors must also carry out their due diligence to protect the interests of the organization and its charitable purposes (Bourgeois (2006 at p. 219)). Due diligence includes utilizing the rights and powers of the director and seeking professional advice when necessary. However, it will not provide a defence for all statutory violations, *i.e.*, failure to comply with the anti-terrorism legislation. As Bourgeois notes (2001, at p. 17):

> Due diligence is both a question of fact and of law. What is due diligence will depend on the circumstances, the type of organization and the activities undertaken. In general, directors or officers will meet their obligations if they act *reasonably, prudently and sagaciously* and within the law, including the objects of the organization and the scope of their position or office.

(Emphasis added.)

As such, directors will be exercising due diligence in circumstances in which they fulfill their primary duty of managing the affairs of the corporation. As noted above, this necessarily includes ensuring that meetings are held as required, that the director attends the meetings and is prepared to discuss matters, that corporate records are duly

maintained, and that reports are submitted as required. There is the accompanying need for ongoing training and education in order to ensure directors maintain and enhance their skills and knowledge in the area of the organization's operation, as well as the applicable legislation and case law. In certain circumstances, it will be necessary for the directors to obtain advice from qualified professionals, which can assist in insulating directors from liability. Such circumstances include situations requiring legal, accounting, or financial expertise.

### *Legal Risk Management Committees*

Another means of reducing risk is through establishing legal risk management committees to conduct the reviews of the organization's policies, activities, and associations, and identify risk areas. These committees should conduct a comprehensive audit of the corporation's assets, structure, legal relationships (contractual and non-contractual), and particularly activity-related risks, and the committee should advise the board on implementing due diligence and risk management procedures.

### *Crisis Management Committees*

Like any other organization, charities and nonprofits face the possibility of dealing with sudden emergencies or disasters that threaten their ability to survive. For example, an organization may run out of funds causing it to be unable to meet payroll requirements. Or perhaps a nonprofit has been publicly accused of wrongdoing directly or indirectly leaving the organization with significant damage to its credibility and reputation. In these circumstances, the organization will be better equipped to survive the catastrophe if it had an existing crisis management plan.

While a risk management committee tends to concentrate its efforts on avoiding risk in everyday and urgent matters, crisis management committees focus more on events and circumstances that have the potential to completely disrupt an organization's operations. A crisis management committee should consist of a group diverse enough to consider a full range of crises that an organization might face. Some potential disasters that the committee should consider in developing strategies include: death or injury of a key individual; loss of access to the use of facilities and equipment; loss of crucial

information; and intense media scrutiny leading to irreparable damage to a charity's reputation.[104]

### *Independent Legal Advice*

Directors should obtain independent legal advice in situations where they may be facing a high degree of exposure to personal liability. As noted above, simply resigning is not necessarily a measure that will insulate a director from potential liability. As such, before considering resigning from the board, a director should obtain independent legal advice.

### *Size of the Board*

Careful consideration should be given to the appropriate number of directors required to effectively operate the nonprofit corporation. A smaller board will give directors more effective control over the management of the corporation's affairs, and will help reduce the number of individuals who will be exposed to liability.

### *Transfer of Assets*

No proactive or due diligence steps can completely shield a director from all potential liability. In circumstances where the organization participates in high-risk activities, *i.e.*, work with children, it may be advisable for the director to transfer his or her personal assets to his or her spouse in advance of joining the board in order to aid in shielding the assets in the event of a finding of liability. However, such an action is not advisable after the director has joined the board as it may be viewed as a fraudulent conveyance in order to avoid creditors.

### *Checklists*

The use of a checklist in order to ensure the nonprofit corporation has complied with all legal requirements is an effective tool in any corporation's risk management strategy. Whether it is prepared by the directors or available through professional advisors, a checklist can guide the board through its duties to ensure all bases are covered. A

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[104] A useful resource in this respect is <http://www.imaginecanada.ca>.

sample Legal Risk Management Checklist for Charities is available at <http://www.charitylaw.ca>.

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