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ONTARIO COURT DECLARES FUNDRAISING CONTRACT VOID AND IMPOSES PENALTY

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A. INTRODUCTION

A recent passing of accounts in *The AIDS Society for Children (Ontario) v. Public Guardian and Trustee* (9 May 2002), (Ont.Sup.Ct.) [unreported] has raised serious concerns about the enforceability of certain fundraising contracts. For a background to the judicial passing of accounts in this case, reference should be made to "*Charity Law Bulletin No. 9*", dated September 29th, 2001, that provides a commentary on the earlier decision of the Ontario Court of Justice in *Ontario (Public Guardian and Trustee) v. The AIDS Society for Children (Ontario)* 105 A.C.W.S. (3rd) 1044 (the "*AIDS Society*"), as well as an article entitled "*Looking a Gift Horse in the Mouth", Avoiding Liability in Charitable Fundraising – revised October 5th, 2001*, and Proactive *Protection of Charitable Assets*, November 20, 2001, all of which are available at www.charitylaw.ca. In addition, reference should be made to a subsequent decision of the Ontario Superior Court of Justice in the *Ontario (Public Guardian & Trustee) v. National Society for Abused Women and Children [2002] O.J. No. 607 (QL)*, summarized in *Charity Law Bulletin No. 13* dated April 29th, 2002, also available at www.charitylaw.ca.

B. BACKGROUND TO JUDICIAL PASSING OF ACCOUNTS

The relevant facts in the *AIDS Society* decision as described in Charity Law Bulletin No. 9 are summarized as follows:

- The AIDS Society was incorporated in November, 1994 and obtained charitable status shortly after its incorporation.
- In 1996, the AIDS Society entered into fundraising agreements with two fundraising companies.
- Under one fundraising contract, the AIDS Society was required to pay for all fundraising expenses. Under both contracts, the fundraising companies received a percentage of the remaining proceeds. These arrangements resulted in one fundraising company receiving seventy-six (76%) percent of the monies raised by telephone canvassing and the other fundraising company receiving eighty (80%) percent of the monies raised from door to door canvassing. The Public Guardian & Trustee ("PGT") received complaints from the public about these fundraising arrangements. Upon investigation, the PGT found that even though $921,440.00 had been raised through public donations, no funds had been expended on the charitable programs of the AIDS Society.
- The PGT took steps to suspend the activities of the AIDS Society and Canada Customs and Revenue Agency ("CCRA") subsequently revoked the charitable registration number of the AIDS Society.
- The Court found the AIDS Society and its directors responsible as fiduciaries to the public for all funds collected from the public as donations, including the gross amount of funds received by the two fundraising companies in question.
- The Court also found that the contract entered into between the AIDS Society and the fundraising companies established a principle/agent relationship that meant that the actions of the fundraising companies and their employees were deemed to be actions of the AIDS Society, as agents.
- However, while the AIDS Society and its directors were found to have a fiduciary obligation to apply the monies raised from the public for the charitable purposes of the AIDS Society, the fundraising companies did not have a similar fiduciary obligation.
- The fundraising companies, however, did have a duty to account for the gross amount of monies raised as donations from the public and not simply the net amount that was paid to the AIDS Society by the fundraising companies pursuant to the terms of the fundraising contracts.
- The Court held that, since the donors were not advised that between seventy and eighty (70%-80%) percent of the donations would be deducted for fundraising expenses, the fundraising contracts could be voided as being contrary to public policy as well as for misrepresentation to donors concerning the amount of monies that were actually going to fulfil the charitable purposes of the AIDS Society.

C. SUMMARY OF JUDICIAL PASSING OF ACCOUNTS

Based upon the directions given by the Court in the earlier decision of the AIDS Society summarized above, the PGT proceeded with a judicial passing of accounts of the AIDS Society on May 9th, 2002. The Judgment consists of answers to various questions that were put to the Court. As only answers to questions are available instead of a full judicial decision, the significance of the Judgment lies more in conclusions that can be drawn from the monetary impact of the answers to the questions than in any substantive comments that might add to what the Court had said in its earlier decision.

The questions put to the Court and answers provided are summarized below, together with a commentary on the implication of the Court's answers:

1. The Court was asked whether the fundraising contracts between the AIDS Society and the two fundraising companies were void for being contrary to public policy. In this regard, it was alleged by the PGT that the contracts should be found void because the percentage of fundraising costs was unreasonable. The Court answered that the contracts were indeed void as being contrary to public policy because the fundraising contract provided that seventy to eighty percent (70%-80%) of the proceeds were to be paid to the fundraising company. The consequences of this decision are significant for charities, their directors, and third party fundraising companies where the payment under a fundraising contract entitles the fundraising company to receive a high percentage of the donations, i.e. (70%) percent. It is not clear whether other similar fundraising contracts would be found to be void as being contrary to public policy. However, given the judicial pronouncement in this case and in the National Society for Abused Women and Children case, there is a distinct possibility that other similar types of fundraising contracts might be found void by the courts. It would therefore be important for both charities and third-party fundraising companies to carefully review the terms of their fundraising contracts to ensure that the resulting percentages of fundraising costs will not be found objectionable in the opinion of the Court, or in the alternative, to seek direction of the Court if there is uncertainty in this regard.

2. The Court was next asked whether the fundraising contracts, if not found void based on unreasonable fundraising costs, would be void as being contrary to public policy because of a violation of the 80/20 disbursement quota under Section 149.1 of The Income Tax Act of Canada ("ITA"). The Court declined to answer this question, since the Court had already determined that the fundraising contracts were void. However, the fact that the PGT had submitted to the court that non-compliance with the 80/20 disbursement quota might void a fundraising contract on this basis will mean that charities and their directors will need to determine whether there is compliance with the 80/20 disbursement quota in relation to fundraising expenses, an issue that is not always easy to get clarity on.

3. Having found that the fundraising contracts were contrary to public policy, the Court was next asked what percentage of the disbursement paid by the AIDS Society to the fundraising companies were reasonable fundraising costs that could be kept by those companies. The Court answered that none of the fundraising costs were reasonable. Whether this blunt response was based on the fact that no monies had been used for the charitable purpose of the AIDS Society or because the percentage of fundraising costs was excessive is not clear. However, what is evident is that where fundraising contracts are found to be void, the Courts may have no alternative but to find that all of the fundraising costs, even those at a lower percentage, are unreasonable and cannot be found to be justified. In other words, too high of a percentage share of fundraising proceeds may result in voiding all of the fundraising costs, not just the fundraising costs above an acceptable amount, whether that reasonable amount is determined to be the statutory 20% provided for under the 80/20 disbursement quota under the ITA or some other percentage.

4. Having found that the fundraising contracts were void as being contrary to public policy and that no fundraising costs or disbursements in the accounts were acceptable as reasonable fundraising costs, the Court was then asked to determine whether the AIDS Society and its three (3) directors were liable for the amount of disallowed disbursements. The Court answered that both the AIDS Society and all three of its directors were liable for the disbursements and determined that the amount of unreasonable fundraising costs that they were liable for was $736,915.71. This liability was joint and several to each of the directors. What is important to note is that the breach of the directors' fiduciary duty arose from the fact of having entered into an imprudent contract, not from any conflict of interest or any personal benefit they might have received from the transaction, as was the situation in the National Society for Abused Women and Children. Instead, the directors of the AIDS Society were personally liable for all of the fundraising costs even though there was no evidence that they had received any personal benefit whatsoever from the objectionable fundraising arrangements.

5. The Court was then asked whether the two fundraising companies were liable for the unreasonable fundraising costs along with the AIDS Society and its directors. The Court answered that the fundraising companies were liable on a joint and several basis with the AIDS Society and its directors. Given the Court's extension of liability to the fundraising companies to repay fundraising costs they had received, third party fundraising companies will now have a vested interest in ensuring that their fundraising contracts are acceptable to the Courts and to the PGT for their own protection, in addition to ensuring that fundraising contracts are legal from the standpoint of their clients.

6. The Court was then asked whether or not the matter was an appropriate case to impose a penalty by way of a fine upon the AIDS Society and the fundraising companies pursuant to Section 4(k) of the Charities Accounting Act. In this regard, section 4(k) of the Charities Accounting Act provides as follows:

"(k) imposing a penalty by way of fine or imprisonment not exceeding twelve months

> upon the executor or trustee for any such default or misconduct or for disobedience to any order made under this section;"

The Court answered the question by imposing a $50,000.00 penalty upon the directors of the AIDS Society, but surprisingly did not do so to either the AIDS Society or the fundraising companies. The decision not to impose a penalty upon the AIDS Society likely reflects the fact that the AIDS Society did not have any assets. The fact that the directors of the AIDS Society were the ones held liable for the $50,000.00 penalty underscores the fact that, at the end of the day, where a charity itself is held liable at law for a matter, the directors of the charity will generally be held to account personally where the directors have failed in their duties to adequately manage and protect the charitable property entrusted to them.

7. The final question that the Court was asked to determine was "what should be done with the $37,935.50, which the Court was holding in trust." The Court decided that those monies would be paid between two (2) charities presumably having similar charitable purposes to the AIDS Society in accordance with the "cy prés" jurisdiction that the Courts have over charitable property, i.e. to apply the property as "near as possible" to its original charitable purpose.

D. SUMMARY COMMENTS

Given the devastating financial consequences to the directors of the AIDS Society on a personal basis from having authorized unreasonable fundraising contracts, this case will no doubt result in directors and charities now wanting to carefully review contracts entered into with third party fundraising companies with their legal counsel in order to ensure that the contracts comply with the Courts' expectations. In addition, directors of charities may also need to look at the fundraising costs associated with retaining fundraisers as employees as well, since the Court did not draw any distinction between the cost of third party fundraising arrangements and employing fundraisers in relation to determining what are reasonable fundraising costs.

As many charities which retain third party fundraising companies or employ professional fundraisers may have difficulty meeting the 80/20 percent disbursement quota required under the *ITA* with regard to fundraising costs, there would now appear to be cause for concern by directors of such charities, particularly since directors could be faced with personal liability for having permitted unreasonable fundraising costs. However, since the courts in Ontario have not articulated what are reasonable fundraising costs, it is difficult for directors of charities, as well as third party fundraising companies, to know what will be acceptable to the Court. In this regard, it may be in the best interest of charities, directors, and third party fundraising

contractors to have the matter clarified, either through the introduction of fundraising legislation in Ontario or by an application for directions from the Courts to determine the viability of normal third party fundraising contracts which involve fundraising costs that exceed twenty (20%) percent of the donations received.

Until this matter is clarified, either through legislation or through judicial interpretation, charities which raise funds in Ontario will continue to face considerable uncertainty in fundraising. This uncertainty may also impact on third party fundraising contracts elsewhere in Canada, given the fact that courts in other provinces will often follow Ontario decisions. This possibility is now particularly relevant in the Province of Saskatchewan where the new *Charitable Fundraising Businesses Act*, partially in force since July 15, 2002, permits a charity to apply to a court to obtain an order declaring a fundraising contract void for being contrary to public policy.

The issues raised in the AIDS Society case are ones that charities, directors of charities, their legal counsel, and third party fundraising companies will need to closely monitor instead of dismissing as an anomaly. With there now being three (3) decisions by the Ontario Courts in little more than twelve (12) months concerning the reasonability of fundraising contracts, there is little doubt that the issues being raised by the Courts will continue to be an on-going concern to the charitable community at large.

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