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CHARITY LAW BULLETIN NO. 121

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JULY 31, 2007

Editor: Terrance S. Carter

COURT UPHOLDS CORPORATION'S RIGHT TO REGULATE QUALIFICATIONS OF DIRECTORS

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A. INTRODUCTION

Although courts have traditionally expressed reluctance to interfere in the internal affairs of associations and clubs, in *Rakowski v. Malagerio* (2007), 84 O.R. (3d) 696 (Sup. C.J.), a judge of the Ontario Superior Court of Justice concluded that the court has jurisdiction to intervene in the affairs of an incorporated student federation in order to determine if a policy prohibiting members of other student associations or student advocacy groups from serving on the board of directors was unreasonable, discriminatory, inconsistent with the objects of the corporation, contrary to the *Canadian Charter of Rights and Freedoms* and the *Corporations Act* (Ontario), and passed in bad faith. The court concluded that as the impugned policy was enacted to prevent conflicts of interest, it was neither objectionable on its face, nor was it discriminatory, contrary to public policy or public interest and did not interfere with Charter rights. This *Charity Law Bulletin* will review the decision and discuss its impact for charitable and not-for-profit corporations.

B. BACKGROUND

The applicant, Bryan Rakowski ("Rakowski"), was a full-time student at Humber College Institute of Technology & Advanced Learning ("Humber"), and a member of the respondent Humber Students' Federation ("HSF"), a corporation without share capital, incorporated under the *Corporations Act* (Ontario). HSF represents 16,000 full-time students at Humber and has an annual budget of $4.5 million. Its objects include representing the needs and interests and advocating on behalf of the student body at Humber within

the college and externally. In December 2005, in response to concerns that members of the board of directors might have "divided loyalties", the board of directors passed the impugned Policy 17, entitled "Director Loyalty & Commitment", which provides in part:

> [E]xcept in relation to HSF organizations or HSF sanctioned organizations, a Director shall not be a member, or hold a position on the board of directors, of any other student association or student advocacy group throughout his or her term as a Director.

The members of HSF approved the policy at a Special General Meeting of the members in April 2006.

Rakowski, who wished to run for President of HSF and be a member of its board of directors, was a member of a student association called National Educational Association of Disabled Students ("NEADS"), a national organization whose mandate is the self-empowerment of disabled post-secondary students. NEADS was neither an HSF organization nor sanctioned by HSF. Rakowski brought the application to strike down the policy.

HSF defended the policy and challenged Rakowski's standing to bring the application, as well as the court's jurisdiction to make the order sought. Further, HSF submitted that the application should be dismissed because Rakowski should have proceeded to the HSF Governance Review Committee with his complaint.

C. COURT'S JURISDICTION

HSF submitted, amongst other things, that under section 129 of the *Corporations Act* (Ontario), HSF had the authority to pass Policy 17, as it permits directors of a corporation to pass by-laws not contrary to the act or the letters patent to regulate the qualification of the directors. Further, HSF submitted that the *Corporations Act* (Ontario) does not have an oppression remedy provision and does not grant members rights to interfere in the governance of the corporation beyond the ability to vote for the directors at the annual general meeting.

Likening the corporation to an association or club, Justice Paul Perell acknowledged that courts have traditionally expressed reluctance and sometimes refusal to interfere with the internal affairs of associations and clubs for a variety of reasons. One of those reasons is that the nature of the relationship of the members of an association is intentionally designed by the members of the association to be informal and non-legal. Justice Perell suggested that "just as some promises are intended to be contractual and some are not, persons may decide to associate in informal ways that are not meant to call for judicial supervision. The courts tend to

respect these choices." However, it was noted that courts do get involved to determine if a principle of natural justice was breached, in situations where a member is expelled, temporarily or permanently disqualified from participating in its activities or disciplined for breach of the rules, or where the process of expulsion, disqualification or discipline is fundamentally unfair. In addition to the court's inherent jurisdiction, Justice Perell also pointed to instances where special statutory provisions or the law of contract will also permit the court to intervene.

Although the case at bar did not fit neatly into a pre-existing categories, Justice Perell concluded that the court did have jurisdiction as the circumstances were close enough to the territory of expulsions, disqualification and discipline of members, as well as being close enough to the contract interpretation cases that consider the legal relations between members of a voluntary association that the court can examine the by-law and consider striking it down. Justice Perell further concluded that although Rakowski had an alternative procedure available to him, the court would not exercise its discretion to decline to employ its power of judicial review.

D. ANALYSIS OF POLICY 17

Justice Perell proceeded to review the applicant's suggestion that Policy 17 was offensive and unreasonable on its face, as it, amongst other things, contradicts the important values articulated in the HSF Mission Statement and Code of Ethics and failed to promote student participation and awareness. It was further suggested that the policy was designed "with the guide of 'loyalty' to squelch dissent and debate."

Noting that the objections to the policy had to be measured against the objects of HSF under its letters patent, HSF's mission statement and its role in the college's community, Justice Perell suggested that if you divorce the allegation of an improper motive, it was possible to view Policy 17 as "a reasonable and lawful policy for the governance of a student organization whose purpose was 'to represent the needs and interests and to advocate on behalf of the student body of Humber College' and whose mission statement was to 'endeavour to advocate for the protection and betterment of quality education and student life.'" When viewed in this light, Justice Perell concluded that the policy was not unreasonable, discriminatory, inconsistent with the objects of HSF, contrary to public policy, contrary to public interest or contrary to the Charter, as the policy did not interfere with freedom of speech or association. In this regard, an HSF director would not be prevented from expressing his or her views about any issue and an HSF member would be free to associate

with other organizations. The HSF member would only be prevented from being a director of HSF while being a member of a non-sanctioned student organization. In the court's view, the qualification to becoming a director was held to be a reasonable pre-condition to holding office.

The court went on to conclude that it is reasonable to demand that a director not be in a conflict with the organization's undertaking to be an advocate for students of Humber College. Justice Perell stated, "Policy 17 is designed to prevent the situation where a Director, who will have a duty to act in the best interests of HSF as a student organization, would also have a duty to act in the best interests of another student organization. If this is an interference with freedom of association, it seems to me that it is a reasonable and even necessary one."

E. COMMENTARY

The decision in *Rakowski v. Malagerio* ("*Rakowski*") raises three important issues: (1) the court's intervention in the internal governance of charitable and not-for-profit organizations; and (2) a director's duties to the corporation; and (3) the corporation's authority to pass by-laws or policies regulating the qualification of members or directors.

1. The Court's Intervention

Although some provinces have prescribed procedural safeguards to enable the courts to protect the rights of members, and others have developed membership oppression provisions giving jurisdiction to the courts to entertain applications by members, there remain a number of provinces, like Ontario, where the incorporating legislation is silent on these issues. In these circumstances, although the courts may retain a limited "supervisory" jurisdiction, the courts will generally adopt a policy of "non-involvement" in the internal decisions of not-for-profit organizations. The limited supervision will be exercised by the courts so as to ensure that the rules and procedures of an organization are properly followed, the rules of natural justice are complied with and there is no bad faith in decision-making. In general, courts will not review the merits of a decision and they will not take on the role of an appeal body.[1]

[1] For a more thorough discussion of the courts' intervention in the internal governance of not-for-profit organizations, see Jane Burke-Robertson, "Natural Justice, Members and Not-For-Profit Organization: 'Fair Play in Action'" (Presentation to the Canadian Bar Association/Ontario Bar Association National Symposium on Charity Law, May 2007), available at http://www.carters.ca/pub/article/charity/2007/jbr0510.pdf.

In *Rakowski*, the court stated that in reviewing all of the circumstances and considering the allegation of bad faith, the circumstances enabled the court to exercise its jurisdiction and examine the policy to consider if it should be struck down.

2. Director's Duties

Rakowski confirms the long-held view that a director of a charitable or not-for-profit organization owes a duty of loyalty, good faith and avoidance of a conflict of duty and self-interest to the organization, even when the organization is a student organization. Directors of charitable organizations are said to have trustee-like duties and are answerable for their actions as if they were trustees.[2] Although most of the case law on the issue of conflict of interest has traditionally focused on a director's potential conflict with the financial matters involving the organization, i.e. misappropriating corporate assets or opportunities, the courts have also had the opportunity to look at the issue of a director's conflict involving loyalty to different organizations, or in layman's terms "serving two masters." In the case of *820099 Ontario Inc. v. Harold E. Ballard Ltd.*, [1991] O.J. No. 266 (Gen. Div.), aff'd by [1991] O.J. No. 1082 (Div. Ct.), the court held that the fiduciary duty of a director of a corporation is owed to the corporation, not to the shareholders or to any other stakeholder or group of stakeholders, or even a majority shareholder who is responsible for a director's appointment to the board. In discussing the issue of nominee directors, the court offered the following comments:

> It may well be that the corporate life of a nominee director who votes against the interest of his "appointing" shareholder will be neither happy nor long. However, the role that any director must play (whether or not a nominee director) is that he must act in the best interests of the corporation… The nominee director's obligation to his "appointing" shareholder would seem to me to include the duty to tell the appointer that his requested course of action is wrong if the director in fact feels this way. Such advice, although likely initially unwelcome, may well be valuable to the appointer in the long run. The nominee director cannot be a "Yes man"; he must be an analytical person who can say "Yes" or "No" as the occasion requires (or to put it another way, as the corporation requires).

As such, the courts have clearly recognized that situations will arise where the personal or private interests of directors will not coincide with those of the corporation. In such circumstances, the law requires that the personal interest of the director be subordinated to that of the corporation. Corporate

[2] For more information, see Terrance S. Carter and Jacqueline M. Demczur, "The Legal Duties of Directors of Charities and Not-for-Profits" (October 2006), available at www.charitylaw.ca. See also, *Re Public Trustee and Toronto Humane Society* (1987), 60 O.R. (2d) 236 (H.C.J.).

statutes generally dictate a means of addressing a director's conflict of interest. For example, section 71 of the *Corporations Act* (Ontario) and section 98 of the *Canada Corporations Act* require directors who are directly or indirectly interested in proposed contracts or contracts with the company to declare their interest at a director's meeting and abstain from voting on the matter or risk varying penalties depending on the legislation. If a director is in an "untenable position" of serving two masters, the director should consult legal counsel for advice concerning whether he or she may need to declare a conflict of interest and possibly even resign. Acting as a director in the absence of a conflict of interest involving the corporation does not require the director to avoid supporting outside interests. Rather, the director is free to adopt a position based on its merits, provided that it does not conflict with what is in the best interest of the corporation of which the director serves as a director.

3. Authority to Regulate Qualifications

The court's decision in *Rakowski* also confirms that the directors of a corporation have the authority to pass by-laws to regulate the qualification of directors, so long as they exercise this power with *bona fides* and without fraud, oppression, or improper motives. Where a decision is marked by unfairness, partiality, secretiveness, unreasonableness, improper motives, oppression, fraud, or the absence of procedural fairness, the courts will be prepared to intervene. However, this is not a strict standard. As the court observed in *Rakowski*, "there was undoubtedly interpersonal and emotive factors at work" in the adoption of Policy 17 by HSF. Still, the court concluded that the "essential motivation … was a concern that a Director's independence to be an advocate for the students of Humber College not be diminished by obligations to be an advocate for another student association."

F. CONCLUSION

Rakowski does not really establish any new principles of law, but it does confirm some of the well-established principles of which directors of charities and not-for-profit organizations need to aware. Although courts are generally reluctant to interfere with the internal affairs of associations and clubs, it is still important for boards of directors of charitable and not-for-profit corporations to ensure that they act in good faith and generally in accord with the concepts of natural justice, especially in relation to matters of expulsion, disqualification or discipline. Individuals who are considering becoming a director of a charity or not-for-profit corporation need to understand that these standards and principles apply to each organization regardless of size and purpose. Thus, the same standards apply to a sophisticated national charity, a university or college student corporation, as well as a local charity or not-for-profit corporation.

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