THE LAW SOCIETY OF UPPER CANADA

EMERGING ISSUES IN DIRECTORS’ AND OFFICERS’ LIABILITY 2011

Toronto – March 29, 2011

Duties and Liabilities of Directors and Officers of Charities and Non-Profit Organizations

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A. INTRODUCTION

• The 2007 National Survey of Giving, Volunteering and Participating by Statistics Canada reported that a third of all Canadian volunteers hold positions on boards and committees.

• Specifically, many individuals take on the position of director or officer of a charity or non-profit organization (“NPO”).

• There is a mistaken belief that the position of a director or officer on a charity or NPO somehow involves less exposure to liability than a for-profit corporation.

B. BASIC CHARACTERISTICS OF CHARITIES AND NON-PROFIT ORGANIZATIONS

• Membership based as opposed to shareholders.

• Not-for-profit corporations in Ontario are incorporated either provincially under the Corporations Act (Ontario) (“OCA”), or federally under the Canada Corporations Act (“CCA”).

• Not-for-profit corporations encompass entities which are registered charities, as defined under subsection 248(1) of the Income Tax Act (Canada) (“ITA”), and NPOs as defined under paragraph 149(1)(l) of the ITA.

• Frequent confusion in terminology between charities and NPOs.
• Charities
  – Defined by the common law
  – Categorized under the ITA as a charitable organization, a public foundation, or a private foundation
  – Activities must be undertaken to achieve a charitable purpose
  – There are clear tax advantages to obtaining charitable status
    ▪ A Charity does not pay tax on income or capital gains
    ▪ A Charity has the ability to issue charitable receipts to individual donors as tax credits, and to corporate donors as tax deductions, for income tax purposes

• NPOs
  – Common examples of NPOs would include sport clubs, recreation clubs, trade associations and professional associations
  – It is up to Canada Revenue Agency (“CRA”), through an audit, to determine whether or not a corporation qualifies as an NPO
  – An NPO can earn a profit but only so long as it is unanticipated and incidental to carrying out the NPOs exclusively non-profit purposes
  – Tax Advantages for NPOs
    ▪ An NPO does not pay tax on income or capital gains (with certain exceptions)
    ▪ However, an NPO is not able to issue charitable receipts to donors

C. STANDARDS OF CARE
• Directors of for-profit corporations are held to an objective standard of care under the Canada Business Corporations Act ("CBCA") and the Ontario Business Corporations Act ("OBCA")
• A statutory standard of care is not provided for not-for-profit corporations incorporated under either the OCA or CCA, and therefore remains the common law subjective standard of care as articulated in In Re City Equitable Fire Insurance Co
• Canada Not-for-Profit Corporations Act ("CNCA") and Ontario Not-for-Profit Corporations Act ("ONCA") will mirror the objective standard provided for under the CBCA and OBCA
In addition to the subjective standard of care at common law, directors of charitable corporations, as well as NPOs in dealing with charitable property are held to a high fiduciary standard of care

- These directors “must handle the charity’s property with the care, skill and diligence that a prudent person would use. They must treat the charity’s property the way a careful person would treat their own property. They must always protect the charity’s property from undue risk of loss and must ensure that no excessive administration expenses are incurred” (OPGT)

D. DUTIES OF DIRECTORS AND OFFICERS

- Well established law that directors owe a fiduciary duty to the corporation
- The Charities Accounting Act (“CAA”) designates any corporation that is “incorporated for a religious, educational, charitable or public purpose” as a trustee for the purposes of the CAA
  - The courts in Ontario have held that directors of charitable corporations are subject to high order fiduciary obligations similar to those of trustees with regard to charitable property
  - While case law has confirmed that a corporation owns its general assets beneficially and not as trustee for those assets, a corporation can still receive charitable property under express or implied terms in trust

Under the ONCA and CNCA, this approach has in part been codified

- Section 87 of the ONCA and 31 of CNCA state:
  - A corporation owns any property of any kind that is transferred to or otherwise vested in the corporation and does not hold any property in trust unless that property was transferred to the corporation expressly in trust for a specific purpose or purposes
  - Where a charitable corporation holds property subject to express or implied terms of trust for a specific charitable purpose, common law with respect to high fiduciary duties apply in that the corporation would hold those funds as trustee
To Whom is the fiduciary duty owed?

- The Corporation
  - London Humane Society (Re) affirmed that directors of not-for-profit corporations are in a fiduciary relationship to the corporation, not to its members
  - Duty to Act in Good Faith, Honestly, Loyally
    - A director’s sole interest is to the corporation
    - The interests of the director must not be placed in conflict with those of the corporation

Duty of Diligence

- Directors must be diligent in attending to their legal duties
- Accomplished in part by attending board meetings and reviewing the minutes of missed board meetings

Duty of Obedience

- Directors must comply with all applicable legislation and the corporation’s governing documents (letters patent, by-laws, etc)
- Directors must ensure that the corporation and its officers and agents obey the general law applicable to the corporation

Duty to Avoid Conflict of Interest

- Directors must avoid the appearance of a conflict of interest
- OCA and CCA contain provisions for a director with an interest in a contract to declare their interest in order to avoid liability for any profit realized from that contract
- The effect of such a declaration means that the director is not accountable to the corporation or to any of its members or creditors for any profit realized from the contract
ONCA and CNCA, on coming into force, will expand the provisions concerning conflict of interest such that they will apply to both directors and officers and address transactions the corporation enters into on a more general basis as opposed to being limited to contracts.

However, neither the OCA and the CCA currently, nor CNCA and ONCA in the future, will extinguish the common law duty regarding directors of a charity avoiding a conflict of interest.

Directors of a charity could still be in breach of their fiduciary duty at common law.

Duty to Continue

Resignation simply to avoid personal liability is ineffective and may constitute breach of fiduciary duty where the director puts his or her own interests ahead of those of the corporation.

High Fiduciary Duties with Regard to Charitable Property

The following duties relate specifically to the high fiduciary duties where charitable property is involved, whether such property is held by a charity or by an NPO.

Duty to Carry out the Charitable Purpose

Charities can have one or more charitable purposes.

The charity’s resources must be used to carry out the purposes of the charity.

Directors have a positive duty to further the charitable purposes of the corporation.

Duty to Protect and Conserve Trust Property

Directors must protect charitable property.

Directors in Ontario must ensure that such property is appropriately invested in accordance with terms of the Trustee Act.
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- Restricted charitable purpose trusts are no longer recognized as separate trusts distinct from the general assets of the charity for exigibility purposes
  - Therefore, it is important for directors to consider what steps can be taken to assist in protecting those trusts
  - Duty to Act Gratuitously for the Charity
    - Directors in Ontario cannot receive any remuneration, either directly or indirectly, from the charity
    - Can seek approval for remuneration from the court under section 13 of the CAA for payment for services other than as a director but difficult to attain

- The onus will be on the applicant to show that such payment for services “is in the best interest of the trust in light of the circumstances and the basic rules of equity which affect trustees”
  - Duty to Account
    - Directors of charities must keep records to evidence that the charitable property has been properly managed
    - The Ontario Public Guardian and Trustee (“OPGT”) can compel the directors of a charity to pass the accounts of the organization before the court

- Duties to the Public/Donors
  - A charity and its directors are accountable to the public for all monies publicly raised from it, and to utilize such monies to further the objects of the charitable institution
  - Charities, as well as fundraising companies have a duty to account for the gross amounts of monies raised from the public and not simply the net amount that was paid to the charity pursuant to the terms of the fundraising contracts
  - Courts have agreed with the OPGT’s position that the public has an interest in seeing that charitable property for which income tax receipts have been issued is not diverted to fund litigation between groups within the charity
Duties owed to Members

- Directors have certain duties to the members of the corporation, although it is not specifically a fiduciary relationship
- Directors must ensure that the corporation abide by the terms of its letter patent and by-laws
- Case law affirms that a corporation, as well as the individuals who become members, which would include directors, have entered into an implicit contractual obligation to comply with the constating documents and by-laws of the corporation
- Officers, who carry out the day to day management, are generally under the same fiduciary obligations described above where they direct the corporation

E. FIDUCIARY DUTIES CONCERNING CHARITABLE PROPERTY FOR NON-PROFIT ORGANIZATIONS

- Fiduciary duties of directors and officers with respect to charitable property also apply where NPOs raise funds intended for charitable purposes, such as when a community service club raises money for a local hospital
- Each special purpose charitable trust fund for a particular application is generally required under common law to be held separately from other restricted trust funds and cannot be commingled with other funds
- NPO fundraising for a charitable purpose may not commingle any of its restricted charitable purpose funds with its general operating funds

F. LIABILITIES OF DIRECTORS AND OFFICERS FOR BREACH OF DUTIES

- Liability for Breach of Fiduciary Duty
  - Examples of breach of fiduciary duty can include mismanagement of corporate funds and property, or the appropriation of corporate opportunity
  - Directors and officers are liable for any loss that the corporation suffers as a result
- Liability for Breach of Trust
  - As the guiding mind of the corporation, directors and officers are responsible for the way charitable property is handled and to adhere to the charitable objects of the corporation found in its letters patent
• Liability for Special Purpose Charitable Trusts
  – A special purpose charitable trust is property held by a charity in trust for a specific charitable purpose that falls within the parameters of the general charitable purpose of the charity as set out in its constating documents
  – To the extent that a gift constitutes a special purpose charitable trust, the charity can only use the gift to accomplish the specific charitable purpose established by the donor and for no other purpose

• Liability for Breach of Corporate Authority
  – When directors permit the corporation to act beyond the scope of the authority set out in the corporation’s objects, the directors may be found personally liable for ultra vires actions
  – The issue of acting ultra vires will no longer be a concern once the ONCA and CNCA come into force, as they each give the corporation the same powers of a natural person as those given to directors of for-profit corporations under modern business corporations legislation
  – However, every director is still under a duty of obedience to comply with the objects stated in the letters patent or by-laws

• Liability for Imprudent Investments
  – Section 10.1 of the CAA confirms that sections 27 to 30 of the Trustee Act apply to all charities and indirectly NPOs that deal with charitable property unless the constating documents of the charity or the gift agreement state otherwise
  – The Trustee Act establishes a prudent investment standard governing investment decision-making of trustees of charitable property and permits trustees to delegate their investment decision making to qualified investment managers under certain circumstances
G. SELECTED STATUTORY DUTIES, LIABILITIES AND PROTECTION

- Penalties for non-compliance with statutory requirements can result in directors, and possibly officers, as well as being subject to fines, repayment of debt and even imprisonment.
- Federal Statutes
  - Canada Corporations Act
    - Directors of a charity or NPO are jointly and severally liable for all unpaid wages due for services by employees for the corporation while they were directors if sued within six months after the wages became due.
  - Canada Not-for-Profit Corporations Act
    - In addition to the continuing similar liability for wages described under the CCA, directors and officers of charities and NPOs need to be aware that the CNCA generally expand the rights and remedies available to members of not-for-profit corporations.
  - Income Tax Act
    - Directors of charities may be personally liable if the charity fails to comply with numerous reporting requirements under the ITA, for example, filing of annual charity information return, T-3010.

- Failure to file the requisite information with Industry Canada can lead to personal liability with no limitation period or defence for a director who permits a breach to occur.
- CNCA also enhances the accountability of directors to members by providing members with the power to remove directors by ordinary resolution at any time.
- Members will be able to apply to the court for an oppression remedy, a court-ordered liquidation, a derivative action and compliance and restraining order.
Directors have been found liable for the sums due because they did not exercise the degree of care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances under subsection 227.1(3) of the ITA.

Court has affirmed that the standard of care under ITA is no less rigorous for a director of a not-for-profit corporation than for a director of a corporation run for profit.

In this regard, with respect to compliance under the ITA, directors of not-for-profit corporations will be held to an objective standard of care in ensuring that all returns and source deductions are completed.

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Anti-terrorism Considerations

- Directors of charities, as well as NPOs may also need to consider addressing due diligence considerations under Canada’s broad reaching anti-terrorism legislation, particularly those operating outside of Canada in conflict zones.
- Directors and officers of charities can face fines, penalties and even imprisonment under numerous sections of the Criminal Code.
- If a charity’s assets are frozen or seized, the charity’s directors and officers could be exposed to civil liability for breaching their fiduciary duty to protect the organization’s charitable assets, as well as be exposed to criminal charges.

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Ontario Statutes

- Corporations Act
  - Directors are jointly and severally liable to the employees, apprentices and other wage earners for all debts due for services performed for the corporation, not exceeding six months wages and twelve months vacation pay.
  - Failure to keep proper books, records and registers at the head office of the corporation and failure to make such books, records and registers available for inspection by entitled persons may result in personal liability for the directors.
- **Ontario Not-for-Profit Corporations Act**
  - Like the CNCA, the ONCA expands member’s rights and remedies

- **Charities Accounting Act**
  - OPGT can seek an order under section 4 of the CAA if he or she is of the opinion that there has been a misapplication or misappropriation of any charitable funds, an improper or unauthorized investment of any monies, or failure to apply charitable property as directed by the donor

- Third-parties can bring applications under subsection 6(1) without notice to the charity or anyone else, with the court being able to order the OPGT to conduct a public inquiry under the Public Inquiries Act
  - Could result in an application by the OPGT to obtain a court order requiring the charity to comply with the terms of the donor direction in accordance with s.4(d) of the CAA
  - Subsection 10(1) of the CAA permits two or more individuals to make a court application where they allege a breach of a trust created for a charitable purpose or seek the direction of the court for the administration of a trust for a charitable purpose

- **Statutory Protection for Directors**
  - **Canada Not-for-Profit Corporations Act**
    - A director is not liable if he or she has exercised the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances
    - Due diligence defence includes good faith reliance on financial statements and reports of professionals
    - Derivative or oppression action are precluded in the case of a “religious corporation”
      - To apply, the act or omission, conduct or exercise of powers must be based on a tenet of faith held by the members of the corporation and was reasonable to base to decision on a tenet of faith
H. INDEMNITIES AND INSURANCE FOR DIRECTORS AND OFFICERS OF CHARITIES

- The OCA permits a corporation, with the approval of the members at a meeting of the members, to indemnify a director or officer for all “costs, charges and expenses” arising from an action in relation to the director’s execution of the duties of his office.

- Regardless of which corporate statute applies, Regulation 4/01 under the CAA requires that prior to a charity consenting to the indemnification of its directors on purchasing D&O insurance, the directors must consider certain factors enumerated in the regulation.

- The ability for directors or officers of the corporation to receive indemnification or purchase insurance is also restricted in that in doing so it must not render the corporation insolvent.

- The regulations also stipulate that the terms of an insurance policy purchased for the directors and officers must not impair a person’s right to bring an action against a director or officer.

- OPGT takes the position that a director of a charity ought to be indemnified only for those acts properly undertaken in the administration of the charity or undertaken in breach of trust under an honest and reasonable mistake.

- Court of Appeal recently held in Pandher v. Ontario Khalsa Darbar that the common law position that absent a finding of the directors pursuing their own interests ahead of those of the corporation, the court should not award costs against the directors on a personal basis.
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