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Part 2: Qualified to be a Director? Considerations in Becoming and Remaining a Director

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Qualified to be a Director?
Considerations in Becoming and Remaining a Director

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A. INTRODUCTION
• It is important for associations and their boards to understand the legal process that is involved in recruiting and keeping directors in order to strengthen and develop board loyalty and continuity
• This session will look at various considerations in order to qualify and keep directors, both from the standpoint of mandatory legal requirements, as well as best-practice guidelines
B. WHAT ARE THE REQUIREMENTS TO BE QUALIFIED AS A DIRECTOR UNDER CORPORATE LEGISLATION?

1. Federal Legislation
   • *Canada Corporations Act (CCA)*
     - Directors must be at least 18 years of age and have power under law to contract
     - Directors do not have to be a member of the corporation
     - Ex-officio directors are permitted
   • *Canada Not-for-Profit Corporations Act (CNCA)*
     - In order to be qualified as a director, an individual must
       - Be at least 18 years of age
       - Have not been declared incapable by a court in Canada or in another country
       - Not have the status of a bankrupt

2. Provincial Legislation
   • *Ontario Corporations Act (OCA)*
     - Directors must be at least 18 years of age and not an undischarged bankrupt
     - Directors are required to be members of the corporation at the time of election or appointment, or within ten days of being elected or appointed
     - Ex-officio directors are permitted
     - Qualification requirements apply whether the director is elected or ex officio
• Ontario Not-for-Profit Corporations Act, 2010 (ONCA)
  – In order to be qualified as a director, a person must
    ▪ Be at least 18 years of age
    ▪ Not have been found to be incapable of managing property under the Substitute Decisions Act, 1992 or under the Mental Health Act
    ▪ Have not been declared incapable by a court in Canada or in another country
    ▪ Not have the status of a bankrupt
  – Not required to be a member of a corporation, unless the by-laws state otherwise
  – Ex-officio directors are permitted
  – The requirements apply whether the directors are elected or are ex-officio

C. “INELIGIBLE INDIVIDUALS” UNDER THE INCOME TAX ACT (ITA)

• The 2011 Federal Budget introduced the concept of “ineligible individuals”, which has become a new de facto eligibility requirement for directors of registered charities under the ITA but rules do not apply to NPOs
• CRA had been concerned that applications for charitable status were being submitted by individuals who had been involved with other charities and Registered Canadian Amateur Athletic Associations (RCAAAs) that had their status revoked for serious non-compliance
• In the past, CRA could not refuse to register or revoke the status of a registered charity or RCAAA based on these concerns

• Budget 2011 now permits CRA to refuse or revoke the registration of a charity or a RCAAA or suspend its ability to issue official donation receipts, if a member of the board of directors, a trustee, officer or equivalent official, or any individual who otherwise controls or manages the operation of the charity or RCAAA is an “ineligible individual”
• An “ineligible individual” is a person who
  – Has a “relevant criminal offence” – convicted of a criminal offence in Canada or similar offence outside of Canada relating to financial dishonesty (including tax evasion, theft or fraud), or any other criminal offence that is relevant to the operation of the organization, for which he or she has not received a pardon
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- Has a “relevant offence” — convicted of an offence in Canada in the past five years (other than a relevant criminal offence), or similar offence committed outside Canada within the past five years relating to financial dishonesty or any other offence that is relevant to the operation of the charity or RCAAA
  - Includes offences under charitable fundraising legislation, convictions for misrepresentation under consumer protection legislation or convictions under securities legislation

- Has been a member of the board of directors, a trustee, officer or equivalent official, or an individual who otherwise controlled or managed the operation of a charity or RCAAA during a period in which the organization engaged in serious non-compliance for which its registration has been revoked within the past five years
- Has been at any time a promoter of a gifting arrangement or other tax shelter in which a charity or RCAAA participated and the registration of the charity or RCAAA has been revoked within the past five years for reasons that included or were related to its participation

- Why charities and RCAAs should be concerned
  - CRA has yet to make clear what the effect of having an “ineligible individual” on the board will be, but revocation is a statutory right of CRA
  - CRA has so far stated that they
    - Will look at the particular circumstances of a charity or RCAAA
    - Will take into account whether appropriate safeguards have been instituted to address any potential concerns
  - Unfortunately, CRA has not stated what those circumstances are and no explanation of what the safeguards might be has been given
Charities need to be concerned about the due diligence required to ensure that an “ineligible individual” does not become involved or continue to be involved in the oversight or management of the charity.

Budget 2011 states that a charity will not be required to conduct background checks, but even if the charity wanted to review the information required to independently assess whether an individual is ineligible, it may not be publicly or easily available.

- Possible to search for relevant criminal offences in Canada, but abroad?
- Many relevant offences (e.g., Securities Act convictions) are not tracked in publicly available databases in Canada, or unlikely abroad.

Names of directors and like officials of revoked charities are not maintained in a single publicly available database.

- Not likely that an individual who otherwise controlled or managed the operation of a charity would be identified in publicly available documents – likely information solely in CRA’s control.
- Onus is now shifted to charities to comply in a situation where it is impossible to ensure 100% compliance because the necessary information is not available.
- This new cause for revocation is similar to a strict liability offence – no due diligence defence is available in the legislation.
- Charities will be required to undertake other forms of due diligence and hope CRA will excuse any inadvertent non-compliance.

Charities must find a way to deal with a director that is an ineligible individual (generally only the members can remove a director).

- Bylaws will now need to include a new requirement that the directors must not be an “ineligible individual” as defined under the ITA at the time that they become a director and during their tenure.
- Removal of management staff that are “ineligible individuals” could have important employment law ramifications.
- For existing staff it may difficult to remove them.
- For new management staff it will be important to include this in an employment contract.

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Concerns about privacy
- If CRA alleges that a person is an “ineligible individual”, who is to receive such information and how is the information to be protected once received?
- Should the alleged “ineligible individual” be given an opportunity to rebut the allegation or is it to be left up to the charity to do so on the individual’s behalf?
- If so, what personal information can be used to rebut the allegation?

D. APPROPRIATE SCREENING DURING THE DIRECTOR RECRUITMENT PROCESS
- Neither charities nor NPOs are legally required to conduct background checks on potential directors, but the ability to garner information about potential directors is obviously important, considering the CRA’s stance on “ineligible individuals” for charities
- Issue arises when a charity or NPO attempt to independently assess whether an individual is suitable, as the information being assessed may not be publicly or easily available
- Other than criminal record checks, there is nothing else that is publicly available
- However, there are still appropriate screening techniques that can be done by a nominating committee
  - Google searches
  - Application form can ask relevant questions but the storage of that information needs to be stored in accordance with the privacy policy of that organization
  - Preferred qualification requirements (e.g., a faith requirement) established by bylaw or by nominating process
    - However, need to determine whether a preferred qualification requirement does not constitute a prohibited ground for discrimination under the Human Rights Code
    - If preferred qualification requirement does prima facie violate the Human Rights Code, then check to see if there is an exemption available under the Code
Criminal Record Checks
- Possible to search for relevant criminal offences in Canada through local police force
- Need to create guidelines in order to determine which offences are relevant and would disqualify an applicant from being a director, as not all criminal offences may be relevant

Bankruptcy Search
- Generally must not be an undischarged bankrupt in order to qualify as a director
- In some situations where there is doubt, it may be necessary for a nominating committee to do a bankruptcy search
- Can be done through the Office of the Superintendent of Bankruptcy Canada

References
- Important to follow up on references provided by the candidate
- Specific questions should be asked so that a determination of whether the applicant is suitable can be undertaken
- References from charities that the applicant has previously worked with would be a valuable source of information

Interviews
- Interviews with members of the nominating committee would give an opportunity to discuss the applicant’s skills, interests, background and availability for a director position
- Any doubts about the candidate’s suitability could be addressed at this point

E. SPECIAL SCREENING REQUIREMENTS FOR ASSOCIATIONS OPERATING OUTSIDE OF CANADA
- Charities and NPOs that operate outside of Canada can be vulnerable to terrorist organizations
- Precautions should be taken by charities and NPOs to ensure that they are not being used
  - by terrorist organizations posing as legitimate entities
  - to exploit legitimate entities as conduits for terrorist financing, including for the purpose of circumventing anti-money laundering measures
  - to conceal or obscure the clandestine diversion of funds intended for legitimate purposes to terrorist organizations
Canadian Security Intelligence Service ("CSIS")

Security Checks

- The discovery of even a suggested link between a director and a terrorist group could expose a charity to de-registration or failure to obtain registration in the first place
- Potential board members should be advised that a CSIS security check may be carried out on them by CRA
- This is the reason why application for charitable status (T2050) and annual information returns (T3010) for charities require the birth date of directors to be included

Anti-Terrorism Due Diligence Procedures

- All new and existing board members of charities and NPOs operating internationally should be required to complete appropriate disclosure statements so that an anti-terrorism assessment can be done
- Disclosure statements would include information required to complete appropriate search on terrorist lists with government agencies
- Disclosure statements should include consents from the directors to share the results of such statements with legal counsel, board members, executive staff, and nominating committee members as necessary
- Statements should be required from all directors on a regular basis

F. DEVELOPING AND IMPLEMENTING A CONFLICT OF INTEREST POLICY

1. Federal Legislation Requirements

- CCA
  - Directors directly or indirectly interested in a contract with the company must declare such interest at a meeting of directors of the company
  - Declaration occurs at the meeting of directors at which the question of entering into the contract is first taken into consideration,
  - If the director is not at the date of that meeting interested in the proposed contract, at the next meeting of the directors held after he becomes so interested
- Where the director becomes interested in a contract after it is made, the declaration is to be made at the first meeting of directors held after the director becomes interested.
- Directors may not vote in respect of any contract or proposed contract in which they are interested.

**CNCA**

- Contains provisions requiring directors to disclose their interest if they are a party to a material contract or transaction, a director or officer of a party to a contract, or have a material interest in a party to a contract.
- Directors must disclose their interest during meetings of directors or of committees of directors at which a contract is first proposed.
  - Can also be disclosed at the first meeting after a director becomes so interested.
  - Important ongoing obligation, as a director may be required to account for any profit or gain realized on the contract or transaction.

- Any contract or transaction that has been disclosed is not invalid and the director would not be required to account for any profit if:
  - Proper disclosure was made.
  - Directors approved the contract.
  - Contract was reasonable and fair to the corporation when it was approved.
2. Provincial Legislation Requirements

• OCA
  - Directors who are directly or indirectly interested in a proposed contract or a contract with the company shall declare their interest at a meeting of the directors of the company
  - Declaration occurs at the meeting of directors at which the question of entering into the contract is first taken into consideration,
  - If the director is not at the date of that meeting interested in the proposed contract, at the next meeting of the directors held after he becomes so interested
  - Where the director becomes interested in a contract after it is made, the declaration is to be made at the first meeting of directors held after the director becomes interested

• ONCA
  - ONCA provides that directors must disclose their interest if they are a party to a material contract or transaction, a director or officer of a person who is a party to a contract, or if they have a material interest in any person who is a party to a contract
  - Similar procedure as found in the CNCA
    - Directors must disclose their interest at the meeting at which a proposed contract is first considered
    - If the director becomes interested after the contract is made, disclosure must be at the first meeting after he or she becomes so interested
    - Disclosure of the nature and extent of his or her interest should be to the corporation or entered in the minutes of meetings of the directors

As with CNCA, any contract or transaction that has been disclosed is not invalid and the director would not be required to account for any profit if

- Proper disclosure was made
- Directors approved the contract
- Contract was reasonable and fair to the corporation when it was approved
3. Common Law Override with Regards to Charities

- Notwithstanding what is set out in corporate legislation, charitable corporations are subject to a common law override.
- At common law, directors of charities are akin to trustees of charitable property and therefore cannot receive any benefit from the charity without court approval.
- As such, simply disclosing a conflict of interest and not voting is not enough.
- If the charity is going to proceed with a proposed arrangement with a director, then the director would need to resign.

4. Developing and Implementing a Conflict of Interest Policy

- General operating bylaw may be silent may or include a conflict of interest provision.
- Bylaw provision may simply repeat the statutory provisions or it may establish additional requirements.
- If the organization is a charity, the bylaw provision should require a director to resign if there is a pecuniary conflict of interest that continues even though the director has declared a conflict of interest and has not voted.
- There may be other non-statutory conflicts of interest issues to be addressed, such as not being an employee or board member of a competing association.

- Conflict of interest provision in bylaw can also be supplemented by a specific conflict of interest policy.
- Alternatively, a conflict of interest policy can be worked into an overall board conduct policy, which policy could include:
  - a conflict of interest section
  - a confidentiality section
  - performance expectations for directors
- A conflict of interest policy should apply to all directors whether they are ex-officio or elected.
- Policy should be referenced in the director application and/or consent form to be a director.
- Adherence to conflict of interest policy should be renewed on a regular basis.
G. DEVELOPING AND IMPLEMENTING A CONFIDENTIALITY POLICY

1. The Legal Duty of Confidentiality
   - Directors have a legal duty to retain in confidence and not disclose any information received as a director which is determined to be of a confidential nature
   - This confidentiality can be lost if the information is disclosed, for example in litigation
   - Not-for-profit corporate legislation limits disclosure of director meeting minutes to the directors
     - Implied confirmation of their confidentiality

2. The Content and Implementation of a Confidentiality Policy
   - Preamble
     - Statement of recognition by the organization concerning the importance of confidentiality
     - Statement that directors of the organization owe a fiduciary duty of loyalty to the organization and to its members
     - Discussion of responsibility of directors to act honestly and exercise their best care, skill and judgement for the benefit of the organization
     - Director’s responsibility to protect the private nature of the deliberations of the board and ensure the confidentiality of information of the organization

   - Exercise good faith in respect to all transactions involving the organization
   - Fiduciary duty to put interests of the organization first
   - Continuing responsibility to comply with the policy
   - Agreement from directors that, during and after their service on the board/committee, they will keep confidential all direct or indirect information acquired pertaining to the organization and its activities
     - List of information could include: membership information, program information, financial information, employee information, any litigation information, legal advice, etc.
If organization has a privacy policy, include a statement that it needs to be complied with.

If organization involves in fundraising, should require the donors’ personal and financial information must be held confidential.
  – Requirement to sign acknowledgment of director’s agreement to safeguard privacy and protect confidential information of the organization.
  – Statement of where to direct questions with regard to confidentiality policy.

Failure to Safeguard Privacy and Confidentiality
  – Statement of organization’s responsibility with regards to addressing any infractions of the policy, and how the board of directors will evaluate the breach and whether there is a need for redress.
    • Verbal warnings, letter outlining breach and concerns of board.
    • Inclusion of a statement with regards to repercussions of a severe breach of the policy.
      • e.g., possible resolution by the majority of the board to send a report to the members recommending a resolution by the members to remove the director from his or her position before the end of their term.

Alternative approach would be to have directors pre-sign a resignation at the time of joining the board, which could be triggered in the discretion of the board if there was a serious breach of confidentiality.

  • Review of Policy
    – Policy should be reviewed on a regular basis
    – Changes be approved by the board in accordance to the corporation’s by-laws
    – Indicate when communication of changes will be done and to whom
  • Acknowledgement
    – Statement signed by director that the director acknowledges having read the policy and agrees to be bound by its terms
    – Understanding that failing to comply with the policy will result in appropriate disciplinary action.
H. HOW TO REMOVE AND/OR DISCIPLINE A DIRECTOR FROM OFFICE

1. Federal Legislation
   - **CCA**
     - Legislation only provides for the creation of by-laws to remove directors by members
     - Normally include a provision in the bylaw that allows a members resolution to remove a director by 2/3 of the members present
   - **CNCA**
     - Enhances the accountability of directors by providing members with the power to remove directors by ordinary resolution at any time
     - May apply to court for an oppression remedy except for religious corporations
     - May result in a court appointing directors in place of or in addition to all or any of the directors then in office

2. Ontario Legislation
   - **OCA**
     - Members may remove any director before the expiration of his or her term of office by a resolution passed by at least two-thirds of the votes cast at a general meeting of which notice specifying the intention to pass such resolution has been given
   - **ONCA**
     - Members of a corporation may, by ordinary resolution at a special meeting, remove from office any director or directors, except persons who are directors by virtue of their office

3. Board Removal or Discipline of Board Members
   - Removal or discipline of directors must be done by members
   - However, the court could be asked to intervene after a questionable election and order new elections of directors
   - A possible indirect approach so that the board can remove or discipline a director
     - Have the prospective director agree to a board code of conduct that would allow the board to discipline or remove a director
     - Have the directors file an undated resignation with the corporation when elected to the board
I. RETAINING DIRECTORS THROUGH PROTECTION

1. Statutory Due Diligence Defence

• Nothing under either the CCA or OCA

• CNCA
  – Directors provided with “reasonable diligence” defence
  – Directors are not liable if they exercise the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances
    ▪ reliance in good faith on the corporation’s financial statements or the report of “a person whose profession lends credibility to a statement made by that person”
  – But must comply with CNCA, regulations, articles, by-laws and any unanimous member agreement

• ONCA
  – Directors provided with a “reasonable diligence” defence
    ▪ Reasonable reliance on officers and employees of the corporation and on professional advice
  – Director is not liable if they exercised the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances
    ▪ Including good faith reliance on financial statements and accounting professionals

• Directors will need to ask themselves in seeking to rely upon a “reasonable diligence” defence the following
  – Have they analyzed and understood the issue before them?
  – Have they retained independent advisors or advisors recommended by management and do the advisors have the requisite expertise and experience?
  – Have they tested and challenged their advisors, or merely followed recommendations without question?
  – Is the amount of time that they have spent on the issue proportionate to its importance and complexity?
Have they debated the issue amongst themselves and engaged in a candid exchange of views?
Were they actually present at the applicable board meeting?
Were the discussions and decision properly documented, for example, in minutes or resolutions of the board?

2. Indemnification
   a) Indemnification Under CCA and OCA
      • CCA permits a corporation to indemnify a director or officer for all costs, charges and expenses sustained in any action commenced or prosecuted against him, in relation to the execution of the duties of his office except
         – costs that occur by his own wilful neglect or default
      • 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

   b) Indemnification Under CNCA and ONCA
      • Mandatory Indemnification
         – A present or former director or officer, due to their association with the corporation, is entitled to indemnification against all costs, charges and expenses reasonably incurred by them in connection with the defence of any civil, criminal, administrative, investigative or other action/proceedings in which they have been involved
• Permissive Indemnification
  – Indemnification of a present or former director or officer is permitted against all reasonable costs, including an amount paid to settle an action or satisfy a judgment, in respect of any proceeding in which the individual is involved because of their association with the corporation.
  – Corporation may advance the money for costs of a proceeding referred to above, provided that the director or officer is found to have acted honestly and in good faith with a view to the best interests of the corporation.

• Prohibited Indemnification
  – Corporation cannot indemnify if the director or officer failed to act honestly and in good faith.
  – Corporation cannot indemnify in criminal or administrative proceedings or actions enforced by a monetary penalty, if the director or officer had no reasonable grounds for believing that their conduct was lawful.
  – If no court approval, indemnification is prohibited in an action by or on behalf of the corporation to obtain judgment in its favour, where a director or officer may be made a party due to their association with the corporation.

• Indemnification Involving a Charity
  – Regardless of which corporate statute applies, Regulation 4/01 under the Charities Accounting Act ("CAA") requires that prior to a charity indemnifying its directors, the directors must consider certain factors enumerated in the regulation, which consideration need to be documented.
  – The ability for directors of the corporation to receive indemnification or purchase of director and officer insurance must not render the corporation insolvent.
  – The Ontario Public Guardian and Trustee 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.
d) What Does Indemnification Involve?
• Corporate indemnification generally provides compensation for the following
  – Legal fees
  – Fines that were paid under a statute
  – A financial settlement that results from a lawsuit
  – Any other obligation that a director was required to fulfill
• Corporate indemnification should always be implemented but may be of limited practical benefit
• Indemnification is only as good as the financial security of the corporation and its insurance
• Indemnification is therefore tied to the strength of the insurance coverage of the corporation

3. Insurance Protection
a) Insurance coverage will generally include
• General liability insurance
• Directors’ and officers’ insurance
• Sexual abuse and/or harassment coverage
• Insurance for particular risks, i.e. counseling, non-owned auto, third-party use of property, employment benefits and practices liability, etc.
• Wrongful dismissal coverage

b) Both the CNCA and ONCA permit a corporation to purchase and maintain personal liability insurance for the benefit of a present or former director or officer of the corporation, or another individual who acts or acted at the corporation’s request as a director or officer or in a similar capacity of another entity
• Under the ONCA, however, director and officer insurance may not be purchased for a charity unless the corporation complies with the Charities Accounting Act and its regulations that permits the purchase of such insurance
• The same provisions would apply to the CNCA, although nothing is stated in the CNCA to that effect
c) Additional Factors to Consider with Director and Officer Insurance
   • How much coverage does the policy provide for?
   • Who are the named insureds?
   • Does insurance cover all former and existing directors, officers and committee members?
   • Are there exclusionary clauses that limit the protection offered by the policy, such as sexual abuse?
   • Is coverage on a “claims made basis” or on an “occurrence basis”?
   • Is there a historical record of insurance policies?
   • Are there geographical limits to the coverage?

d) Insurance may not provide coverage for actions by public authorities against directors for breach of trust, improper investments, or violations of the Anti-terrorism Act (Canada), Bill C-45 amendments to the Criminal Code (Westray Mines) or other similar strict liability legislation

e) Need to advise agent in writing each year of all activities of the charity or not-for-profit organization and all known risks and ask for a written report back on the coverage available

4. Other Means of Due Diligence in Reducing Risk to Directors
   • Legal Risk Management Committees
     – Legal risk management committee needs to be formed to conduct review and identify risks
     – Need to conduct ongoing review of assets and risks utilize legal risk management checklist
   • Independent Legal Advice
     – Independent legal advice needed for directors in high risk situations
     – Directors may need to seek independent legal advice before resigning from the board of directors
- Size of the Board
  - Reducing size of board reduces risk
  - Smaller board may also allow for more effective control
- Committees and Advisory Boards
  - Committees and advisory boards can be an effective means of attracting volunteers without the risk of being directors
  - But board of directors must always remain in control

- Transfer of Assets by Board Members
  - Directors will always be somewhat exposed to liability risks
  - Therefore directors may want to consider transferring personal assets to spouse
  - However, any transfer of assets should be done before becoming a director so as not to defeat claims of creditors
  - Independent legal advice for both spouses is recommended

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