
**THE OTTAWA REGION
Charity & Not-for-Profit Law Seminar**

Ottawa – February 18, 2010

Fiduciary Duties and Conflict of Interest

By Jane Burke-Robertson

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OVERVIEW OF TOPICS

- What is a Fiduciary?
- The Duty of Care
- The Duty of Loyalty
- Ratification of Conflict of Interest
CCA/OCA
- Ratification of Conflict of Interest CNCA
- Conflict of Interest Policies

A. WHAT IS A FIDUCIARY?

- A fiduciary is a person having a legal duty to act primarily for another person's benefit
- Nature of the relationship, not the "specific category of actor involved that gives rise to the fiduciary duty"

- Fiduciary duties are imposed by the law to protect those who are vulnerable from those who have power over them
- The beneficiary is peculiarly vulnerable to or at the mercy of the fiduciary holding the discretion or power. [*Fame v. Smith* (1987) 2 S.C.R. 99]

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- The courts have considered the corporate director a fiduciary since the 19th century
- In 1974 this SCC extended the category to include a corporation's senior officers [*Cdn Aero Service Ltd v. O'Malley* (1974) S.C.R. 592]

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- In general terms, the fiduciary duty requires directors and officers to act honestly and in good faith with a view to the best interests of the corporation
 - “They must respect the trust and confidence that has been reposed in them to manage the assets of the corporation in pursuit of the realization of the objects of the corporation....” [*Peoples Department Stores (Trustee of) v. Wise* S.C.C. [2004]]

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- **Whether a fiduciary acts in good faith or bad faith has no bearing on whether the fiduciary is in breach of that person’s duties**
- **Acting in good faith is not a defense**

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Termination of Relationship

- **Fiduciary duties continue beyond termination of the relationship between the fiduciary and the beneficiary for a reasonable period of time**
- **Fiduciary cannot evade responsibilities by terminating the relationship**

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- **Directors’ fiduciary duties can be divided into two main branches:**
 - **The duty of care**
 - **The duty of loyalty**

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B. THE DUTY OF CARE

- **Directors have a duty of competence, i.e. a requirement to be informed and to act with a certain level of skill**
- **This duty is comprised of the following responsibilities:**
 - (i) The Duty to Act Honestly**
 - **Directors must deal honestly with the organization and not act for an improper purpose**

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(ii) The Duty of Diligence

- **Directors must be familiar with all aspects of the corporation by being prepared for and attending meetings and acting on an informed basis**
- (iii) The duty to Exercise Power**
 - **Responsible for furthering the objects of the organization**
 - **Must not fall into inaction and inattention.**

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(iv) The Duty of Obedience

- **Directors must comply with all applicable laws and the organization's governing documents and ensure that corporate decisions are implemented**
- (v) Duty of Confidence**
 - **A director must not make use of confidential information obtained while a director and by virtue of his/her directorship**

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- **The Standard of Care**
 - A director’s conduct is measured in accordance with a certain standard of care
 - Potential for personal liability if the applicable “standard of care” is not met in the performance of the director’s duties

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- **No clear “standard of care” or single standard of care that is applicable in all circumstances**
 - May vary by statutory duty
 - May vary based on individual background, training and experience

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- May vary by legal status of organization – trust, unincorporated association, corporation, statutory corporation
- May vary as between “not-for-profit” and charitable (trustee or “akin to trustee”)

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Standard of Care – Objective or Subjective?

- *Re City Equitable Fire Insurance Co.* – early 20th century

Degree of skill required in what “may reasonably be expected from a person of his knowledge and experience”

- Subjective, not an objective standard of care
- Director’s own knowledge and experience important

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- Directors need to ask: What level of skill and care can reasonably be expected from a person with my knowledge and experience?
- Most corporate law statutes (not CCA or OCA) have codified an objective standard
- The law imposes an even higher standard of care on directors of charities

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Canada Not-For-Profit Corporations Act

- S. 148 of the CNCA codifies objective standard of care
 - Every director and officer of a corporation in exercising their powers and duties shall
 - (a) Act honestly and in good faith with a view to the best interests of the corporation
 - (b) Exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances

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Business Judgment Rule

- Canadian courts have developed a rule of deference to business decisions made by directors (presumption in favour of directors)
- The courts will look to see that directors made a reasonable decision, not a perfect one
- In arriving at a decision, directors must show that they acted prudently and on a reasonably informed basis [Peoples Department Store inc. (Trustee of) v. Wise [2004]]

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Additional Common law Principles

- Directors are not required to give continuous attention to the organization's affairs
- The responsibilities of directors are intermittent and performed at periodic board and committee meetings
- Directors need not attend all board meetings

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- Directors may entrust certain matters of business to officers of the organization
- Directors are justified, in the absence of grounds for suspicion, in trusting that officers of the company will perform in their duties honestly

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C. DUTY OF LOYALTY

- **Directors will fulfill the duty of loyalty if they:**
 - **Act in good faith and in the best interests of the corporation (and not their own interests)**
 - **Avoid situations where they have competing duties/loyalties**

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- **Personal Benefit**
 - **A conflict of interest arises when persons are in a position, or perceived to be in a position, to benefit financially (or create a benefit to a family member or other organization with which they are associated) by virtue of their position within the organization. [Dealing with Conflicts of Interest by K. Liegel]**
 - **Typically involves a contract or transaction involving the organization and the director**

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- **Competing Loyalties**
 - **Directors can also find themselves with competing loyalties between the organization they serve and other business and personal relationships**
 - **Directors have the burden of proving they acted in best interests of the corporation**
 - **Typically no contract or transaction involved**

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• **What persons might produce a conflict of interest in your organization?**

- **Typically those who have an ability to influence decisions of the organization and who have access to information not available to others**

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• **The best way to address conflicts of interest in an organization is:**

- **To understand how they may arise**
- **To educate directors and others aware of the need to avoid conflicts**
- **To require board and others to disclose potential conflicts**
- **To establish a policy for dealing with conflict problems as they occur**

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• **Difficulty in Identifying Conflicts**

- **A director facing a potential conflict has to have sufficient awareness of his or her fiduciary duty to be able to recognize a conflict**
- **The identification process is based on the director’s own subjective analysis**
- **To fulfill the fiduciary duty, must make the required declaration of conflict of interest to the board**

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• **Questions to ask yourself:**

Conflict Type #1: A personal conflict between the director's duty to act in the best interests of the organization and the director's own self interest

What do I have uppermost in my mind? Best interests of the corporation or personal (family) benefit?

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Conflict Type #2: A conflict of duties/loyalties that the director owes to the organization he or she serves and to another organization/person

Do my conflicting duties to the other organization impair my ability to act in the best interests of the corporation in even the slightest way?

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It helps to Keep the Organization's Objects in Mind...

- A director must have undivided allegiance to the organization's objectives
- Keeping the organization's public purpose in mind can help directors make choices that will benefit the organization's public purpose and not private interest

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Procedure Board to Follow after Declaration:

- Follow conflicts policy to determine if there is a conflict of interest
- If the answer is yes, the board must use best business judgment and exercise its duty of care to the organization in deciding what steps to take, i.e. director to abstain from voting, resignation (as detailed by its policy)
- If a contract or transaction, follow corporate legislation
- Vote must be by a disinterested majority of the directors

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Some Common Situations Involving Conflicts

- **Multiple Directorships**
 - The case law is clear that there is no absolute rule regarding multiple directorships
 - In each case, the question of breach of fiduciary duty will depend on its facts
 - May be possible to act in best interests of both corporations but where active competitors, will likely be impossible to avoid a finding of conflict

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- It is rarely practical to keep off the board everyone who has potential conflict problems
- The board should exclude people with extreme conflicts, i.e. the son of the chief staff officer, a director or officer of a close competitor
- “Appointments involving extreme cases of potential conflict have sometimes worked out well, but it is usually prudent to assume they will not.” [Governing Boards, C. Houle, 1997]

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- **Corporate Opportunity**
 - Where a director becomes aware of an opportunity related to the organization’s objectives - (*whether in capacity as director or not*)
 - The director must first disclose the opportunity to the organization and make it available to the organization before he or she pursues it or suggests it to a third party

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- **Representative Directors**
 - Often directors sit on a board in a representative or nominee capacity – can result in divided loyalties
 - Being a nominee director does not relieve the director of his or her obligation to fulfill his or her duties to the corporation – even where those duties conflict with the nominator’s wishes
 - Conflict of interest policy is key in determining process to follow

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In the case of representative directors:

- Fiduciary duty of a director is owed to the corporation and not to stakeholders, even an important stakeholder such as a majority shareholder or other person who is responsible for the director’s appointment
 - *820099 Ontario Inc. v. Harold E. Ballard Ltd.*

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“It may well be that the corporate life of a nominee director who votes against the interests 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 ...”

[Harold E. Ballard Ltd.]

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“The nominee director .. must be an analytical person who can say “Yes” or “No” as the occasion requires (or to put in another way, as the corporation requires)”

[Harold E. Ballard Ltd.]

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- **If a director is in an “untenable position” of serving two masters, the director may have to resign**
- **Director nominated to the board by another does not entitle the director to prefer the interests of that person to the interests of the corporation**
- **Director must be concerned first and foremost with the interests of the corporation**

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D. RATIFICATION OF CONFLICT OF INTEREST

- The law countenances to a very limited degree, a director's gain through conflict of interest, but only where:
 - The director discloses the conflict
 - The director abstains from voting
 - Ensures appropriate corporate approval
 - The organization is not a charity

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- Directors of Charities
 - Directors of charities must still comply with declaration requirements
 - But the law does not permit directors of a charity to remain on the board where gain through conflict of interest (e.g. direct or indirect remuneration) without court approval
 - Conflict of interest policy of a charity should reflect possibility of different types of conflicts and consequences

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- The conflict of interest provisions in the CCA/OCA are statutory offshoots of the common law fiduciary duty
- At common law, if disclosure has been made by the director, there is no breach of fiduciary duty
- Where no disclosure, any agreement between the corporation and one of the directors, whether reasonable and fair or not, may be set aside at the Corporation's request

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- This rule is extended to situations in which a director has an “interest” in a contract with the corporation, i.e. the director is also a shareholder, officer or director of the other contracting party

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S. 98 of the *Canada Corporations Act*

- A director who has a direct or indirect interest in a contract or proposed contract with the corporation has a duty to declare the interest at a meeting of directors
- An “interest” should be interpreted as any interest which would have the least influence on a director who is called upon to make a decision

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Timing of Disclosure - CCA

- At the meeting of directors at which the question of entering into the contract is first taken into consideration
- However, CCA also permits directors to meet requirement under the Act by providing a “general notice” to directors to the effect that the director has an interest in the other company

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Degree of Disclosure - CCA

- **General notice must contain sufficient information**
- **The conflicted director or officer should ask himself whether his disclosure will enable the board to quantify the benefit that he would receive (or that would be received by a family member or organization)**
- **Benefits usually financial, but may also be of a non-financial nature**

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Voting Where Declaration or General Notice

- **Subsection 98(4) requires that an interested director abstain from voting in respect of any contract or proposed contract**
- **If the director does vote, the vote cannot be counted**
- **Should the director abstain from discussions?**

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After Declaration:

- **Board must review proposed contract and approve it by a disinterested majority**
- **Directors to use their best business judgment/duty of care**
- **Directors must rationally believe that the conflict will not harm the corporation and that the contract is a proper one and fair, despite the benefit to fellow board member**

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Consequence of Breach

- Courts will not grant a remedy for every breach of the conflict of interest rule – precondition is that harm or damage occurred
- General Offence Penalty
 - Directors will be liable to fine of \$1000 and imprisonment not more than a year for doing anything contrary to the legislation or failing to comply (where specific penalty not prescribed)

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E. CNCA - RATIFICATION OF CONFLICT OF INTEREST
Section 141 – General Disclosure Requirement

- A director or officer shall disclose the nature and extent of such person’s interest in a *material contract or transaction* to the board of directors when the proposed contract/ transaction is discussed for the first time
- If the director or officer acquires an interest in the contract only subsequently, he/she shall disclose the interest at the first meeting after the interest arises

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- An “interest” that must be disclosed is defined (unlike the CCA) and consists of:
 - Being a party to the contract or transaction
 - Being a director or officer of a party to the contract or transaction, or
 - Having a “material interest” in a party to the contract or transaction

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- The concept of “material interest” is still relatively new and is not clarified in legislation or case law
- Prudent course - Any contract or transaction which is other than insignificant should be considered material as should any interest which might have the least amount influence on a director who is called upon to make a decision

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- A director’s duty to disclose is limited to the nature and extent of that person’s interest
- Disclosure is required of information about the contract, but there is no need to pass on to the board “every piece of paper and every detail”. As one court recently pointed out in context of the CBCA, “the duty ... is a question of substance, not form”

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- Disclosure is required to the board of directors, not to individual directors or officers or to the auditor
- If a director does not meet disclosure requirement to board, also possible to seek ratification from the members by special resolution as long as proper disclosure to members and contract or transaction is fair and reasonable to the corporation (s. 141(9))

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- The CNCA also contains requirements relating to:
 - Use of general notice as opposed to declaration (where the material contract or transaction would not usually require approval of board)
 - Directors not voting on resolution to approve contract or transaction (with limited exceptions)

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F. CONFLICT OF INTEREST POLICIES

- Purpose
 - To provide tools to address and manage conflicts of interest
- Why?
 - Opportunities for conflicts, both real and perceived, are numerous
 - Fallout can be serious
 - Adopting and following policy is key

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Self-Assessment Exercise: Answer “Yes” or “No”

Does your organization:

1. Have a written conflict of interest policy?
2. Does it define “conflict of interest”?
3. Does it specify the persons who are covered under the policy?
4. Does it require regular disclosure of information related to conflict of interest?

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- 5. Does it specify procedures for handling conflicts of interest when they arise?
- 6. Is the policy signed annually by officers, directors and key employees of the organization?
- 7. Does the board regularly review the conflict of interest policy?

Scores:

- 7: Great. Keep up the good work
- 5-6: Good. But there's room for improvement
- 1-4: Time to get serious. Engage your board and key staff to make needed changes

Standard Elements of a Conflict of Interest Policy

- Identify who it applies to: who are the insiders? Usually directors and officers and can include some senior staff
- Identify disclosure process: Should require prompt disclosure, usually in writing when any real or apparent conflicts are thought to exist
- Identify what happens after disclosure (i.e. recusal from voting, generally refrain from discussion, resignation)

- Specify documentation procedures: Board minutes should always record if there was a conflict of interest and how it was addressed
- Consequences for breach of policy
- Develop process to implement: Consider annual re-distribution: reminds directors and others of their responsibilities
- Require disclosure per statute
- Schedule for review and updates

Summary Remarks

- **Conflict transgressions are generally unintentional**
- **Important to take steps to avoid conflicts and to ensure directors are aware of their responsibilities:**
 - Screen out potential board members who present “extreme cases of potential conflict”
 - Adopt and follow a comprehensive written conflict of interest policy and educate board members regarding conflicts
 - Increase transparency by dealing openly and possibly making policy available on your website

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