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## DRAFTING BY-LAWS: PITFALLS TO AVOID

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A partner with the firm, Ms. Oh practices in charity and not-for-profit law, and is recognized as a leading expert in charity and not-for-profit law by *Lexpert*. Ms. Oh has written numerous articles on charity and not-for-profit legal issues, including incorporation and risk management for [www.charitylaw.ca](http://www.charitylaw.ca) and the *Charity Law Bulletin*. Ms. Oh is a regular speaker at the annual *Church & Charity Law™* Seminar, and has been an invited speaker to the Canadian Bar Association, Imagine Canada and various other organizations. Ms. Oh also has a broad range of volunteer experience with several charitable organizations and was formerly a board member and corporate secretary of a national umbrella organization.

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## INTRODUCTORY COMMENTS

- All not-for-profit corporations are governed by the following corporate documents:
  - Letters patent or articles
    - Sets out the corporate name, the purposes, dissolution clause and other important provisions
  - General operating by-law which reflects the governance structure
    - Outlines director qualifications and terms, classes and qualifications of membership, procedures that apply to director and membership meetings, officer positions and other important governance matters
- Not-for-profit corporations can be charities or non-profit organizations under the *Income Tax Act* (Canada)
  - collectively referred to as “NFP Corporations” or “NFPs” in this presentation

- Different types of NFPs
  - Federal incorporation under *Canada Not-for-Profit Corporations Act* (“CNCA”)
  - Provincial incorporation under Ontario *Corporations Act* (“OCA”) which will be replaced by the Ontario *Not-for-Profit Corporations Act* (“ONCA”) or other provincial statute
  - Incorporation under special legislation or other statutes
- Different legal requirements apply to an NFP depending on the governing statute
  - Focus of this presentation is on NFPs incorporated under the CNCA and the OCA

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- From time to time, NFPs may need to amend their general operating by-law in order to reflect updated legal requirements or to address changes to their governance or operations
  - A new general operating by-law can be prepared to replace the entirety of the previous by-law
  - Where an NFP wishes to amend only specific sections of an existing by-law, a shorter by-law amendment can be adopted



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- This presentation does not review the basic legal requirements that apply when drafting by-laws under the CNCA or the OCA/ONCA
- Instead, this presentation reviews selected examples of “pitfalls” to avoid when an NFP is drafting a new by-law or amending an existing by-law
  - A comprehensive summary of all potential “pitfalls” is not provided, as it is not possible to do so



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The topics covered by this presentation are as follows:

- Tips on administrative pitfalls to avoid when drafting by-laws
- Legal considerations to be reviewed
- Drafting pitfalls to be avoided by all NFPs
- Potential pitfalls for federal corporations established under the CNCA
- Potential pitfalls for Ontario corporations established under the OCA
- A few comments are also provided regarding pitfalls that may arise under the ONCA, although that *Act* is not yet in force



## A. TIPS ON ADMINISTRATIVE “PITFALLS” TO AVOID WHEN PREPARING BY-LAWS

### 1. Numbering of By-laws

- By-laws should be numbered sequentially in the order that they are adopted
  - Sequential numbering should be done with all by-laws (including general operating by-laws and shorter by-law amendments)
    - i.e. By-law No. 1, By-law No. 2, By-law No. 3 and so on
  - Using the title of “By-law No. 1” for all by-laws for an NFP can be confusing as to the order in which they were approved

## 2. Retaining Signed and Dated Copies of By-laws

- By-laws should always be signed and dated as of the date that membership approval has been obtained
  - Under OCA the directors may pass by-laws that which are effective as of the date of board approval but only until confirmed at the next annual meeting of members
- A signed and dated copy of each by-law should be kept within the appropriate by-law tab within the corporate minute book of an NFP



## 3. Avoiding Frequent By-law Amendments

- Some NFPs may be in the habit of amending their by-law every year. However, this practice should be avoided for the following reasons:
  - Complexities and inconsistencies can easily occur with frequent amendments to a by-law
  - On-going amendments to by-laws divert resources of the NFP away from its purposes

## 4. Transparency and Collaboration When Seeking Membership Approval Over By-law Amendment

- For open membership corporations, appropriate communication and consultation can be done with members prior to presenting a by-law amendment

- A collaborative process with members to invite questions and feedback prior to seeking membership approval over a by-law amendment can help to avoid potential confusion which can lead to disputes
    - Also demonstrates transparency and can help to increase trust and support from the members
    - For further suggestions on steps that can be taken by an NFP to seek membership approval over a by-law amendment in a collaborative manner, please see slides 22 to 27 of the presentation entitled, “Corporate Documents and Procedures to Help Avoid Governance Disputes”
- <http://www.carters.ca/pub/seminar/charity/2018/Handout2018.pdf>

## B. LEGAL CONSIDERATIONS

### 1. Importance of Working With Legal Counsel To Ensure Accuracy and Coherence of By-laws

- A by-law that is clearly drafted, self-explanatory, and compliant with applicable legal requirements can help to avoid disputes regarding the by-law
- NFP corporations are encouraged to work with their respective legal counsel (experienced in charity and/or not-for-profit law) when preparing a new by-law or amending an existing by-law

## 2. Importance of Confirming Valid Approval of By-laws

- In some cases, there may be inadvertent non-compliance with applicable laws when drafting or revising a by-law. The validity of the by-law may then be subject to legal challenge
- A few examples are provided below
  - Sometimes an unincorporated association will operate in accordance with its constitution, then incorporate several years later and use the constitution as its corporate by-law
    - A new general operating by-law is required upon incorporation; the constitution used by the unincorporated association should not be used by the incorporated successor as different legal requirements apply

- In some cases, a by-law may not have been properly adopted in accordance with applicable legal requirements that apply under the governing statute (i.e. CNCA, OCA) or the by-law approval requirements outlined in the previous by-law
- In those situations it may be necessary to work with legal counsel to review the option of having the directors and members adopt remedial resolutions to confirm, ratify and approve the corporate records notwithstanding the omissions
  - It is not possible to legally “fix” the omissions nor to backdate any resolutions, but properly drafted remedial resolutions can help to document good faith intentions of the NFP





### 3. Importance of Following Correct Procedures at Board and Membership Meetings To Approve By-law

- When amending by-laws, it is important to obtain the necessary approvals outlined in an existing by-law, including the following:
  - Director approval requirements
  - Membership approval requirements
  - Notice of membership meetings to be given
  - Approvals or consultations required from a third party, such as a founding member or a denomination for a local church (if applicable)



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- Where someone wishes to challenge the validity of a by-law approved at a board or membership meeting, by-law can be indirectly challenged on technical or procedural grounds if applicable legal requirements are not properly addressed
  - For example, in order to challenge a by-law approved at a membership meeting, opposing counsel could allege that proper notice of the meeting was not given to members and therefore the by-law adopted at the meeting is invalid



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## C. GENERAL DRAFTING PITFALLS TO BE AVOIDED

### 1. General Comments

The following slides provide selected examples of drafting pitfalls that are of general application.

- Inaccurate and/or outdated description of membership qualifications in the NFP's by-law
  - By-law should stipulate that members must agree in writing to the purposes and the governing documents of the NFP
  - This can help to filter out individuals who are diametrically opposed to the purposes of the NFP from flooding the NFP's membership and electing new board members in an effort to change the direction of the NFP

- Having applications for membership not made subject to approval by the board of directors
- Lack of clarity on requirements that apply where members are subject to limited terms.
  - Some NFPs have one-year terms for members and require annual membership fees to be paid
  - In that case, the by-law should clearly indicate when membership term begins and ends each year
  - The by-law should clearly indicate the deadline by which annual membership fees must be paid in order to preserve voting rights at a membership meeting
  - Lack of clarity on the above issues can result in confusion and disagreements regarding which members are entitled to vote at a membership meeting

- Lack of consistency in provisions within the by-law and provisions within the letters patent/ articles
  - e.g. In some cases, by-laws contain purposes that have been updated over the years, but are different from the purposes in the original letters patent or articles of incorporation
    - In the event of inconsistency the purposes in the letters patent or articles will prevail
- Lack of consistency between the policies of the NFP and the by-law
  - e.g. Conflict of interest (“COI”) provisions within a board policy need to be consistent with the COI provision in the by-law
    - In the event of inconsistency the COI provisions in the by-law will prevail

## 2. Importance of Transition Provisions

- Amendments to an existing by-law may reflect changes to by-law provisions that are completely different to the provisions in an existing by-law
- Where this applies it is essential that the new by-law must outline a clear procedure to be followed to help the NFP transition to the new requirements under the new by-law
  - For example, a new by-law might outline the following changes to director terms:
    - A change to the term to be served by directors from a one year term (in the existing by-law) to a three year term (under the new by-law)
    - A change to the maximum term to be served by directors, from *no* maximum term (under the existing by-law) to a maximum term of three consecutive terms (under the new by-law)

- In this example it is essential that the by-law contain a transition provision outlining how terms and maximum terms for directors are to be calculated
  - The transition provision could indicate that on the date that the new by-law is adopted, each existing director will stand for election to the board and will be deemed to start the first year of the new three year term
  - The transition provision could also indicate that on the date that the new by-law is adopted, each director elected to the board is deemed to start the first term (of a maximum three possible terms) to be served by each director set out in the new by-law



- i.e. each director elected on the date the new by-law is adopted can serve for a maximum of three consecutive three year terms (i.e. 9 consecutive years) according to the new term and maximum term outlined in the new by-law
- Without a clear transition provision that sets out how the director terms are to be calculated under the new by-law, considerable confusion can arise when trying to determine the terms that may be served by individuals elected to the board on the date the by-law is adopted
  - This is of particular importance where individuals have already served on the board for several years immediately before adoption of the new by-law

- Amendments to an existing by-law might also include a change that is fundamental to the governance of the members
  - It is essential that the new by-law must outline the steps to be followed to transition from the provisions of the existing by-law to the new requirements under the new by-law
  - For example, under an existing by-law an NFP might have three classes of members. However, the NFP might want to restructure its membership to reflect only one class of members under the new by-law



- In that case, it would be important to ensure that the new by-law contains a transition provision outlining what is to occur with members who are in the membership classes that will be eliminated under the new by-law
  - As one option the NFP might want to indicate that the members in membership class #2 and #3 (which are outlined in the existing by-law but are being removed under the new by-law) will become members under membership class #1 (which is being retained under the new by-law)



- Without transition provisions outlining a clear process to be followed, an NFP's governance could experience uncertainty and chaos
- Lack of clarity on how to transition to a new by-law can also invite legal challenges on the validity of the new by-law, the status of the directors elected and/or members admitted under the new by-law



### 3. Structuring of Membership

- Enhanced rights are given to members under the CNCA and the ONCA
  - ONCA is not yet in force, and is not expected to come into force until the beginning of the year 2020 at the earliest
  - Both the CNCA and the ONCA are conceptually structured on a business corporate model which gives enhanced rights of members
    - i.e. member rights are similar in many respects to rights of shareholders



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- The following slides provide a few examples of the enhanced rights given to members under the CNCA and the ONCA
- CNCA
  - Right to seek an oppression remedy against the corporation where an act or omission of the corporation is oppressive, unfairly prejudicial or unfairly disregards the interests of a member
  - Right to seek a court order to commence a derivative action on behalf of the corporation
  - Restraining orders against the corporation, directors or officers

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- ONCA
  - Compliance Order - where a corporation, or its directors and officers, fails to comply with the duties set out in the ONCA and regulations, the articles or by-laws
  - Rectification Order - if the name of a person has been wrongfully entered, retained, deleted or omitted from the registers or records of a corporation, that person may apply to a Court for an order rectifying the registers or records



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- Derivative Action - gives members the right to bring an action in the name of the corporation (except religious corporations) to enforce one of its rights
- In light of enhanced rights given to members under CNCA and ONCA (yet to be proclaimed in force), NFPs may wish to consider establishing a closed membership corporation i.e. whereby the directors and members are composed of the same individuals
- Non-members involved in the NFP can be described using a different term:
  - “friends of”
  - “supporters”
  - “adherents” or
  - other terms



## D. DRAFTING PITFALLS TO BE AVOIDED UNDER CNCA

### 1. Careful Review of Mandatory, Default and Optional Clauses Under the CNCA

- Rules that apply under the CNCA and the regulations are highly complex
- Under the CNCA there are different types of rules that apply to by-laws, which are set out in both the CNCA and the regulations under the CNCA
  - Mandatory rules that cannot be overridden by the articles or by-law
  - Default rules, that apply automatically where the by-laws for an NFP are silent on a given issue
    - Default rules can be overridden by provisions within the articles or by-laws





- Optional rules which can be included within the by-laws of an NFP
  - Optional rules would not apply if the by-laws of the NFP are silent on those issues
- In order to avoid having to regularly consult the lengthy CNCA provisions and regulations to understand the requirements that apply to their NFP, the following can be done:
  - Prepare a comprehensive by-law that contains:
    - Key CNCA provisions on mandatory rules
    - The NFP's desired default provisions
    - The NFP's desired optional provisions
  - This can help to streamline matters and avoid considerable confusion

## 2. Rights Given to Non-Voting Members Under CNCA

- Under the CNCA, complex rules apply when an NFP has more than one class of members
- If an NFP has two or more classes of members, members of each class of members will be entitled to vote separately as a class if the corporation wants to make certain changes, regardless of whether the membership class is a voting class or non-voting class
- Separate class votes are required for:
  - Fundamental changes (such as amalgamation, the sale, lease or exchange of all or substantially all of the property of a corporation, other than in the ordinary course of its activities)
  - Certain changes to the rights attached to a class or group of members
- Having one class of members (or a closed membership structure) can help to simplify by-law and governance

### 3. Avoiding Complexity of Proxy Voting Under the CNCA

- The CNCA sets out various methods for absentee voting, where a member may vote at a meeting without attending the meeting in person or electronically
- Some NFPs may be inclined to permit members to vote by proxy
  - Given that the CNCA and the regulations contain very detailed rules that apply, NFPs may wish to reconsider inclusion of proxy voting rights for members if an NFP lacks the infrastructure to comply with the highly complicated requirements that apply



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### 4. Appointment of Directors by Board

- As an optional provision, the CNCA states that the board may appoint directors between annual meetings, provided there is a clause in the articles authorizing the directors to do so
  - The number of appointed directors must not exceed one third of the directors elected at the previous annual meeting of members (“AGM”)
  - The appointed directors can only hold office until the close of the next AGM
- Where an NFP has director terms that are 2 or 3 years, including a clause in the articles permitting the board to appoint up to one third of the directors can result in confusion since the appointed directors can only serve until the close of the next AGM (while the other directors would be serving for a longer term)

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## E. BRIEF UPDATE ON ONCA & BILL 154 (WHICH AMENDS OCA AND ONCA)

- ONCA will apply to Part III OCA corporations
- Technical amendments
  - Ontario Bill 154, Cutting Unnecessary Red Tape Act, 2017, was introduced on September 14, 2017, and received Royal Assent  on November 14, 2017
  - Bill 154 introduced changes to the OCA and ONCA
- Technology - Following the Royal Assent of Bill 154, Ministry's website indicates that it is upgrading technology to support the changes implemented by Bill 154 and to improve service delivery

- 24 month's notice - Ministry's website also states that it is working to bring ONCA into force as early as possible, with a target of early 2020 - thus giving NFPs at least 24 months' notice before the ONCA comes into force
- Bill 154 (Schedule 7) amends certain provisions in the OCA to allow Part III OCA corporations to enjoy some of the modernized rules in the ONCA and provide more flexibility to their operation
- Bill 154 received Royal Assent on November 14, 2017
- Some key changes to the OCA became effective on Nov 14, 2017, and Jan 13, 2018, some will become effective at a later time

- Coming into force date of the ONCA is unknown and ONCA amendments will take effect on various dates
- For further information on these issues, please see Theresa Man's PowerPoint entitled "Recent Changes in Corporate Law Affecting Federal and Ontario Corporations" available at <http://www.carters.ca/pub/webinar/2018/Recent-Changes-in-Corporate-Law-2018-04-25>



## F. POTENTIAL DRAFTING "PITFALLS" UNDER THE OCA

- The following slides set out a few pitfalls that can commonly occur with respect to by-laws for Ontario corporations established under the OCA
  - Limited comments are provided since the OCA is expected to be replaced by the ONCA in the next few years
- All OCA corporations are required to have a by-law. However, a number of OCA corporations do not have a general operating by-law at all
  - This inadvertent omission might easily occur because there is currently no repository for OCA corporations to file a by-law with the Ontario Ministry of Government Services after incorporation
  - In contrast, under the CNCA federal corporations are required to file by-laws within 12 months after the members have confirmed them

## G. POTENTIAL “PITFALLS” UNDER THE ONCA

- Only a few comments are provided regarding the ONCA, as that Act is not yet in force.
- Similar to the CNCA, under the ONCA, where there is more than one class of members, each class of members is entitled to vote separately as a class to approve by special resolution, the following;
  - Certain changes affecting their class of membership
  - Fundamental changes of the Organization (regardless of whether the class of members otherwise has the right to vote)



## 1. Structuring of By-laws

- Similar to the CNCA, there are three types of rules in ONCA
  - Mandatory rules - cannot be overridden by the articles or by-laws
  - Default rules - by-laws or articles can override
  - Alternate rules - articles/ by-laws can include certain optional rules under ONCA
- Minimalist approach by-laws
  - Very short by-law that does not list all of the ONCA’s mandatory rules or default rules that are not to be overridden



- Comprehensive approach by-laws
  - One stop approach - consolidation of all applicable rules within the by-law
  - No need to flip back and forth between the ONCA and the articles, but limited provisions in the articles
  - Can have governance policy manuals to address other matters

## 2. Structuring of Membership classes

- Similar to CNCA, some corporations may want to collapse membership classes into one class and remove non-voting classes to avoid non-voting members obtaining the right to vote on certain fundamental changes
  - Change them into a non-membership category, such as “affiliates”, “associates”, “supporters”

## 3. ONCA Provisions Subject to Charity Law

- Special legislation and charity law will prevail over the ONCA in the event of a conflict
  - This also presently applies to OCA corporations by virtue of the amendments to the OCA under Bill 154
- As a result some provisions of the ONCA will not apply to charities



- E.g. ONCA permits directors to fix their remuneration and receive reasonable remuneration and expenses for their services
  - But directors of charities cannot receive direct/indirect remuneration from the charity
  - The common law prohibition on direct or indirect remuneration of directors of charities is subject to the recent amendments to Ontario Regulations 4/01 to the *Charities Accounting Act* (Ontario) which came into force on April 1, 2018 (the “Amendments”)
    - The Amendments outline certain circumstances where charitable corporations would be authorized to pay directors and related persons for goods, services or facilities

- For further information concerning the Amendments please see “Remuneration of Directors of Charities: What’s New?” by Ryan Prendergast available at <http://www.carters.ca/pub/webinar/2018/Remuneration-of-Directors-of-Charities-2018-05-30.pdf>



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- ONCA permits corporations to invest its funds as its directors think fit (subject to the NFP's articles or by-laws or any limitations accompanying a gift)
  - But charities must also comply with the prudent investor rules described in s.27 to s.31 of the *Trustee Act* (Ontario) (s.10.1 of the *Charities Accounting Act*)



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