

NON-SHARE CAPITAL CORPORATIONS MUST INTERPRET BY-LAWS FAIRLY, REASONABLY AND IN GOOD FAITH

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A. INTRODUCTION

This *Charity Law Bulletin* (“Bulletin”) examines *Chu v. Scarborough Hospital Corp.*,¹ an Ontario Superior Court decision released on December 28, 2006. The decision involved a dispute between Lai Chu (“Chu”), an annual member of the Scarborough Hospital (the “Hospital”), and the hospital’s board of directors (the “Board”). The decision considers several provisions of the *Corporations Act* (Ontario) (the “Act”),² the statute under which many Ontario not-for-profit organizations incorporate. The hospital’s governance structure, classes and terms of membership, the calling of special meetings and the interpretation of by-laws are carefully canvassed by Justice David Brown. Included in his decision to grant Chu’s application was a sound admonishment of the board of directors for having acted unfairly toward the hospital’s membership. In stating that “a board of directors of a *Corporations Act* corporation must interpret and apply its by-laws

¹ [2006] O.J. No. 5147.

² R.S.O. 1990, c. C.38.

fairly, reasonably and in good faith,”³ this decision joins a growing body of jurisprudence which indicates that non-share capital corporations must rigorously follow corporate governance procedures.⁴

B. BACKGROUND

Chu brought an application for court orders pursuant to s. 332 of the Act, a provision pertaining to aggrieved shareholders [and members],⁵ which states that:

Where a shareholder or member or creditor of a corporation is aggrieved by the failure of the corporation or a director, officer or employee of the corporation to perform any duty imposed by this Act, the shareholder, member or creditor, despite the imposition of any penalty and in addition to any other rights that he, she or it may have, may apply to the court for an order directing the corporation, director, officer or employee, as the case may be, to perform such duty, and upon such application the court may make such order or such other orders as the court thinks fit.

Chu had been approved as an annual member of the Hospital on June 29, 2006. In October of the same year, she and other members requisitioned the Board of the Hospital to convene a special members’ meeting. When the Board declined on the basis that the membership of Chu and the others had expired on September 28, 2006, Chu sought court orders “directing the Hospital to recognize her membership and hold the meeting.”⁶

1. By-law No. 1

Scarborough General Hospital and Scarborough Grace Hospital merged in 1999, resulting in the creation of the Scarborough Hospital. Pursuant to the by-laws of the Amalgamated Corporation, the members of the Hospital became its first directors and any others who were later duly admitted as members could then be elected as directors. With regard to the status of subsequent members, two categories of membership were created pursuant to By-law No. 1 (“By-law No. 1”) of the Hospital:

³ *Supra* note 1 at para. 35.

⁴ For earlier Bulletins on this subject, see Terrance S. Carter and Paula J. Thomas, “Non-Share Capital Corporations Must Strictly Adhere to Corporate Governance Procedures” in *Charity Law Bulletin No. 101* (27 October 2006) and “Court of Appeal Update on Corporate Governance Compliance” in *Charity Law Bulletin No. 106* (20 December 2006), online: www.carters.ca/pub/bulletin/charity/index.html.

⁵ As share capital corporations used to be incorporated under this Act prior to the *Business Corporations Act*, R.S.O. 1990, c. B.16, many of the provisions refer only to “shareholders”. Section 133 of the Act enumerates which Part II sections apply to Part III non-share capital corporations. Section 133 states that these provisions “apply with necessary modifications to corporations to which this Part applies, and in so applying them the words “company” and “private company” mean “corporation” and the word “shareholder” means “members”.

⁶ *Supra* note 1 at para. 1.

Annual Members and Honourary Members. Under this by-law, annual memberships expired automatically “on the 31st of July following their admission to Membership.”⁷

Those entitled to vote at annual or special members’ meetings were the directors, the Honourary Members and the Annual Members who had been properly admitted according to the Hospital’s by-laws. As well, under this by-law, they must have paid their annual membership fee at least ninety calendar days prior to the date of any annual meeting or special meeting of the members.

The members possessed certain rights with respect to the Board under By-law No. 1:

- ◆ They were entitled to “remove a director from office by passing a resolution of two-thirds of the votes cast by members entitled to vote at a special general meeting”;
- ◆ If a vacancy on the Board arose “by reason of the failure of members to elect the required number of directors, the Board must call a special meeting of the members to fill the vacancy, in default of which any member may call the meeting”; and
- ◆ A member was entitled “to apply to the court to set aside a contract in respect of which a director has failed to comply with the by-law’s conflict of interest requirements.”⁸

While the by-law did not specify when the annual meetings of members were to be conducted, it did provide for the Board’s power to call annual and special meetings of members. As well, under the by-law it was mandatory that the Board call a special meeting of the members upon the written request of at least ten percent (10%) of the members entitled to vote.⁹

Lastly, By-law No. 1 provided “for the amendment of by-laws by a majority vote of the Board ‘sanctioned by at least a majority of the Members entitled to vote and voting at a meeting duly called for the purpose of considering the said by-law.’”¹⁰

2. Proposed Governance Changes: By-law No. 3 and No. 4

Early in 2006, the President of the Board initiated amendments to By-law No. 1, one of which was to limit the size of the Hospital’s membership. The proposed modifications were included in draft By-law No. 4 (“By-law No. 4”), one of which was to change the categories of membership from voting

⁷ *Supra* note 1 at para. 5.

⁸ *Supra* note 1 at para. 8.

⁹ See also s. 295(1) of the Act, *supra* note 2.

¹⁰ *Supra* note 1 at para. 9.

Annual Members and Honourary Members (both of which had voting rights) to Voting Members and Honourary Members, with the latter no longer possessing voting rights. Of the proposed number of forty voting members, half were to be drawn from the community which the Hospital served, and the other half drawn internally from the Hospital.

On March 9, 2006, the Board recommended that proposed By-law No. 4 be adopted. As the Hospital's annual meeting was scheduled for June 29, 2006, the Board deferred consideration of By-law No. 4 until the upcoming special members' meeting which was to be held on September 28, 2006. In order to achieve this, the Board then proceeded to pass By-law No. 3 ("By-law No. 3"), which read in part as follows:

AND WHEREAS the Board wishes to implement the changes proposed in the governance renewal process at a special meeting of Members to be held in September 2006 (the "Special Members' Meeting");

AND WHEREAS the Board deems it advisable to take the following actions:

c) to postpone the election of Directors until the Special Members' Meeting is held;

...

e) to ensure that those members who have been admitted by the Board at least sixty (60) calendar days prior to the date of the Special Members' Meeting have voting rights at that meeting; ... [emphasis in the court's decision]¹¹

By-law No. 3 enacted certain amendments to By-law No. 1, including the following:

Terms of Membership. Membership in the Corporation terminates automatically upon the happening of any of the following events:

d) in the case of an Annual Member by virtue of subsection 3.2(b) or (c) admitted to membership after the 2006 AGM at the end of the Special Members' Meeting.¹²

By-law No. 3 was to continue to be effective "until revoked at the Special Members' Meeting or such earlier time as the Board determines."¹³ Pursuant to By-law No.1, By-law No. 3 required the endorsement of a majority of the Hospital's members. This was accomplished at the AGM on June 29, 2006, yet only the Board and the Honourary Members were in attendance at this meeting. No

¹¹ *Supra* note 1 at para. 12.

¹² *Ibid.*

¹³ *Supra* note 1 at para. 13.

Annual Members existed at the time of the AGM which was “a departure from past practice.”¹⁴ In that regard, Justice Brown observed:

Effectively, By-law No. 3 was the creation of the Hospital’s directors, receiving no consideration from other Annual Members. The directors, in essence, interpreted section 20.1 of By-law No. 1 as giving them total practice control over the amendment of by-laws to the exclusion of other Annual Members.

I say that the directors enjoyed total practice control over by-law amendments at that time because based on a list of directors and Honourary Members sent by the Hospital to applicant’s counsel in November, 2006, one can conclude that as of June 29, 2006, the number of directors considerably outweighed the number of Honourary Members. Of the 30 members provided by the Hospital, presumably 23 were directors as required by section 4.1 of By-law No. 1 and the remaining 7 individuals were Honourary Members.¹⁵

The court further observed that the manner in which the Board construed the class of Approved Annual Members meant that directors held their membership over a period of one year, while Annual Members were approved in the spring of a given year, attended and voted at the AGM in June, followed by the expiration of their membership one month later on July 31st. This resulted in their “annual” membership term being less than half a year in length.

3. Admission of Applicant as a Member

Directly after the AGM on June 29, 2006, the Board passed a resolution wherein 118 applicants between July 31, 2005 and June 29, 2006, were approved as Annual Members, including the applicant Chu. As such, there were 148 Annual Members with the right to vote as of that date: 118 Approved Annual Members, 23 Directors and 7 Honourary Members. As such, any by-law amendment submitted by the Board at the forthcoming September 28, 2006 special members’ meeting (the “September meeting”) could have been defeated by the Approved Annual Members.

In July of 2006, Chu received a letter confirming her membership, the date of the September meeting and copies of By-law Nos. 1 and 3. Newly admitted members, including Chu, were left with the impression that they would be voting at the September meeting with respect to new directors and on the proposed changes to the governance renewal process. On September 11, 2006, the Board sent a letter reconfirming these same items for the September meeting agenda. Yet on September 22, 2006, less than one week before the September meeting, the Board sent another letter stating that the election of new directors would be the only purpose of the meeting and that the existing by-laws would remain

¹⁴ *Supra* note 1 at 14.

¹⁵ *Ibid.*

in effect. They reasoned that the Members would like to have more time to review and consider the proposed amendments to the by-laws. The September meeting included the election of eleven new directors; By-law No. 4 was not put forward and By-law No. 3 was not revoked.

4. Requisition of Special Members' Meeting

On October 27, 2006, Chu and twenty-nine other members (representing 20% of the 148 total number of members) requisitioned the Hospital in writing for a special members' meeting and included a resolution stating that ““whereas the Scarborough community is dissatisfied with the Board of Directors' repeated failure to act in the best interests of the community’, eleven named directors should be removed from office.”¹⁶ In response, the Hospital stated its position that the Hospital's only Annual Members were the directors and that the October 27 requisition did not meet the provisions of the *Corporations Act*.¹⁷

Within days, approximately 40 additional members added their signature to the requisition and resolution, which was sent to the Hospital by counsel for the applicant. The Hospital's response was that its only current members were the directors and the Honourary Members. The Hospital's President then asserted that, pursuant to By-law No. 3, the membership of each Annual Member had expired at the close of the September meeting. Furthermore, he stated that the Board would not admit new members until the following spring. There was no indication when and if Annual Members would be afforded a voice with respect to the proposed changes to the governance structure.

5. The Status of Chu's Membership

While the Hospital argued that Chu had no standing to bring an application pursuant to section 332 of the Act¹⁸ because her membership had expired at the end of the September meeting, the court resoundingly disagreed on the basis that the Board had failed to approve its Annual Members “in a manner consistent with a reasonable interpretation of the Hospital's by-laws.”¹⁹ Indeed, a reasonable interpretation of the by-laws would not lead to a conclusion that Annual Members were admitted for a period of less than a year.

¹⁶ *Supra* note 1 at para. 24.

¹⁷ *Supra* note 2.

¹⁸ *Ibid.*

¹⁹ *Supra* note 1 at para. 33.

- ◆ By-law No. 1 Misconstrued

The court determined that the Board had misconstrued By-law No. 1 by appointing Annual Members in the spring of each year at least 90 days before the AGM and then taking the position that these same memberships expired one month later on July 31st. Justice Brown stressed the unreasonableness of the Board’s actions and the need for the board to interpret and apply its by-laws in a fair manner by stating:

By employing such an appointment process the Board misconstrued section 3.2(b) of By-law No. 1. A board of directors of a *Corporations Act* corporation must interpret and apply its by-laws fairly, reasonably and in good faith. It was not reasonable for the Board to construe the category of Annual Members’ as being satisfied by appointing members under section 3.2(b) for only four or five months. The Hospital’s by-laws created a class of members described as Annual Members’, and annual means for at least 12 months, not some substantially lesser period of time.²⁰ [emphasis added]

By misinterpreting By-law No. 1 in such a way, for more than half of the year there were no Annual Members in place. Even if the 7 or so Honourary Members requisitioned a special meeting pursuant to section 295 of the Act, they would be outvoted by a majority of the Board. As such, for more than half of the year, “the corporate accountability of the Hospital’s Board would be significantly reduced. This fact reinforces the unreasonableness of the Board’s interpretation of the Hospital’s by-laws.”²¹

- ◆ By-law No. 3 Thereby Tainted

Again, the court found it unreasonable that by the passage of By-law No. 3, the Annual Membership term in that year ran for only three months: from June 29, 2006 to September 28, 2006. The directors and a few Honourary Members were the only members present at the AGM held on June 29 at which time By-law No. 3 was passed. The court reproached the Board for its conduct in this regard, stating that “the confirmation of By-law No. 3 on June 29 simply saw the directors, wearing their hats as individual members, confirming the resolution they passed earlier in March wearing their hats as directors. In no real sense can it be said that members of the Hospital sanctioned By-law No. 3 on June 29; the Boards simply approved its own action.”²² Not only had the proposed changes to governance been removed from the September meeting, By-law No. 3 was to have been revoked by that time.

²⁰ *Supra* note 1 at para. 35.

²¹ *Supra* note 1 at para. 36.

²² *Supra* note 1 at para. 39.

6. The Court's Decision

The court held that Chu remained an Annual Member of the Hospital until June 28, 2007, and as such, she had standing to bring an application pursuant to section 332 of the Act. As well, the court determined that the members had properly requisitioned a special members' meeting pursuant to section 295(1) of the Act. In that regard, pursuant to a combination of sections 295(3), 295(4) and 295(5) of the Act, the Board was required to call forthwith the meeting and transact the business stated in the requisition within 21 days.

C. COMMENTARY

By requiring the respondent Scarborough Hospital Corporation to recognize annual memberships for a period of one year and to call properly requisitioned special members' meetings, the court emphasized that non-share capital corporations are required to follow corporate governance procedures as set out in their governing statutes and by-laws. The decision repeatedly demonstrates that by-laws must be interpreted by boards in a manner that is fair, reasonable and in good faith. Control over governance procedures is to be shared among the various directors and voting members, not concentrated in the hands of the board acting on its own accord. This judgment echoes other recent court decisions which insist that the corporate rules and procedures surrounding non-share capital corporations are not to be interpreted in a manner that is more lenient as compared to share capital corporations. Fairness, reasonableness and good faith is expected in all levels of corporate life irrespective of the type of organization in question.