

NO ENTITLEMENT TO DIRECTOR INDEMNIFICATION FOR BAD FAITH ACTS

*By Nancy E. Claridge**

A. INTRODUCTION

The question of whether a corporation has the legal and financial capacity to provide its directors with an indemnity in relation to their duties for the corporation is a fundamental issue one should consider before accepting a position on the board of directors. While this is true whether it is a for-profit corporation or a not-for-profit/charitable corporation, the issue has special resonance for those acting in a volunteer capacity on the boards of charities, since there is a common law prohibition on remuneration of a charity's directors. Indemnification is the process by which the corporation agrees to cover the cost of, or compensate the director for, any loss or damage sustained as a result of the acts or omissions of the director in the course of his capacity as a director of the organization. The indemnity provides a measure of protection for the director and thereby enables charities to attract capable individuals to the position.

In a recent decision, the Ontario Superior Court of Justice has provided some necessary guidance on the issue of the availability of indemnification for directors of charities or not-for-profit organizations who incur costs in relation to their acts or omissions as directors of the charity. While not creating new law, the decision in *Deol v. Grewal*, [2009] O.J. No. 3217, 2009 CarswellOnt 4521 (Sup. C.J.) (the "Deol Decision") confirms that the principles established in for-profit corporations are applicable to not-for-profit entities. This *Charity Law Bulletin* reviews the highlights of the decision.

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B. BACKGROUND ON CHARITIES PROVIDING AN INDEMNITY

In order for a charity to provide an indemnity to its directors, such power must be included in the organization's by-laws. Many corporate statutes, such as the *Corporations Act* (Ontario), R.S.O. 1990, c. C.38, permits a corporation to indemnify a director for all "costs, charges and expenses" arising from an action in relation to the director's execution of the duties of his office:

Director indemnified in suits respecting execution of office

80. Every director and officer of a company, and his or her heirs, executors and administrators, and estate and effects, respectively, may, with the consent of the company, given at any meeting of the shareholders, from time to time and at all times, be indemnified and saved harmless out of the funds of the company, from and against,

- (a) all costs, charges and expenses whatsoever that he, she or it sustains or incurs in or about any action, suit or proceeding that is brought, commenced or prosecuted against him, her or it, for or in respect of any act, deed, matter or thing whatsoever, made, done or permitted by him, her or it, in or about the execution of the duties of his, her or its office; and
- (b) all other costs, charges and expenses that he, she or it sustains or incurs in or about or in relation to the affairs thereof, except such costs, charges or expenses as are occasioned by his, her or its own wilful neglect or default.

Section 133 of the *Corporations Act* (Ontario) permits a non-share charitable corporation to indemnify its officers and directors. Ontario Regulation 4/01, under the *Charities Accounting Act* (Ontario), R.S.O. 1990, c. C.10, goes further to specifically restrict the indemnification of directors for liability that relates to their failure to act honestly and in good faith in performing their duties. However, prior to a charity consenting to the indemnification of its directors, Ontario Regulation 4/01 requires that the board of directors consider the following five factors:

1. The degree of risk to which the executor, trustee, director or officer is or may be exposed.
2. Whether, in practice, the risk cannot be eliminated or significantly reduced by means other than the indemnity or insurance.
3. Whether the amount or cost of the insurance is reasonable in relation to the risk.
4. Whether the cost of the insurance is reasonable in relation to the revenue available to the executor or trustee.

5. Whether it advances the administration and management of the property to give the indemnity or purchase the insurance.

The Regulation also permits the purchase of insurance as an alternative to the indemnity. However, the purchase of the insurance cannot impair the charitable purpose of the organization, and the insurance or indemnity cannot result in rendering the corporation insolvent.

C. THE DEOL DECISION

The Deol Decision is a costs decision relating to a five-day trial involving a dispute over control of the governance of the Sikh Spiritual Centre Toronto (the “Sikh Centre”), and who were the proper members and directors of the Sikh Centre. The main action was commenced following a series of meetings of the board of directors and the members which resulted in the defendants taking control of the Sikh Centre from the plaintiffs.

In addition to seeking an order setting aside the improper resolutions passed at the invalidly constituted meetings, and setting aside the election of members at these meetings, the plaintiffs sought an order requiring the defendants to repay the \$51,000.00 of the Sikh Centre’s funds paid to the defendant’s solicitors with respect to the matters in issue in the action.

In ruling in favour of the plaintiffs on the main action, the court found, amongst other things, that the defendants had fabricated a meeting and altered the minutes of another, and breached an order of the court by paying the \$51,000.00 to their legal counsel.

In their costs submission, the plaintiffs sought costs on a substantial indemnity basis in the amount of over \$400,000 to be paid by the individual defendants without the benefit of indemnification by the Sikh Centre. The defendants, on the other hand, submitted that no costs should be awarded, but if they were that they should only be on a partial indemnity basis of no more than \$115,000.00. The defendants also submitted that they should be indemnified by the Sikh Centre pursuant to an indemnity provision contained in the Sikh Centre’s By-law No. 1 (which mirrored section 80 of the *Corporations Act* (Ontario)), as well as sections 80 and 133 of the *Corporations Act* (Ontario).

In this regard, the defendants submitted that they were entitled to the indemnity because their acts during the meetings at issue were undertaken to administer and manage the Sikh Centre, in accordance with their duties as officers and directors. They also submitted that such actions were carried out with a view to the best interests of the corporation and not for personal gain. However, the plaintiffs submitted that the defendants were not entitled to be indemnified because their impugned acts as directors were not properly undertaken in the administration of the Sikh Centre and were not undertaken with an honest and reasonable view as to their validity.

The court noted that the legislative rationale for permitting indemnification was twofold: firstly, to provide assurance to corporate directors that they will be reimbursed for any adverse consequences arising from “well-intentioned entrepreneurship” undertaken on the corporation’s behalf; and, secondly, to encourage appropriate director conduct by prohibiting indemnification for director misconduct. If the directors were to be indemnified, their conduct would have to fall within the provisions of the By-law. Specifically, the defendants’ acts would have to be shown to be “in respect of any act, deed, matter or thing whatsoever, made, done or permitted by him, her or it, in or about the execution of the duties of his, her or its office.” Both parties agreed that the applicable test to be applied in determining whether a director or officer is entitled to indemnification in this regard is contained in the decision of *Ontario (Public Guardian and Trustee) v. Unity Church of Truth*, [1998] O.J. No. 1291 (Gen. Div) (the “Unity Decision”). In the Unity Decision, the court, in an *obiter* comment, adopted the position of the Ontario Public Guardian and Trustee (“PGT”) which provided that “a director of a charity ought to be indemnified from personal liability only for those acts properly undertaken in the administration of the charity or undertaken in breach of trust but under an honest and reasonable mistake.” In this regard, the PGT indicated it would object if a charity paid legal fees to cover a director from personal liability for acts which he knew to be wrong. The court in the Deol Decision agreed with this position, stating that “such a test, in my view, permits indemnification based on reasonable good faith behaviour. Bad faith on the part of a director or officer will not entitle him or her to indemnification.”

On the issue as to the scale of costs, the court held that notwithstanding the impugned conduct of the defendants, the conduct did not constitute reprehensible, scandalous or outrageous conduct sufficient to impose substantial indemnity costs. However, the impugned conduct was held by the court to be a breach of the directors’ duties. That breach, coupled with the findings that the defendants disregarded the provisions of

the *Corporations Act* (Ontario) and the By-Law in not providing proper notice to the plaintiff directors of special meetings; the removal and appointment of directors; and electing new members, led the court to the conclusion that the defendants were not acting in the best interests of the Sikh Centre. Instead, it was the view of the court that the defendants were acting in pursuit of their own interests to gain control of the Sikh Centre in circumstances where they knew that if they proceeded in accordance with the By-law and the Act, they would not be in control. Although there were no allegations of misuse of corporate funds or misappropriation of property, the court further held that the impugned conduct constituted *mala fides*, disentitling the defendants to indemnification.

Finally, although some defendants submitted that they should not be personally liable for costs as they had virtually no connection to the factual issues in dispute, the court concluded that they would be jointly and severally liable since there was no evidence that any of the defendants took issue with the improper actions of the board.

The plaintiffs were awarded costs on a partial indemnity basis, fixed at \$186,000.00 inclusive of disbursements and costs. The defendants were not entitled to an indemnity for the costs awarded or for their own legal costs incurred.

D. CONCLUDING COMMENTS

With regard to the issue of whether a charity is financially able to effectively provide an indemnity to its board of directors, the Deol Decision makes it clear that the directors must always give careful consideration to their actions, as their actions may disqualify them from indemnification. This is not new law and is a standard position for both for-profit and not-for-profit corporations, including charitable corporations. In this regard, the Supreme Court of Canada laid out three pre-conditions to a director receiving an indemnity from a corporation: (1) the person must have been made a party to the litigation by reasons of being a director or officer of the corporation; (2) the costs must have been reasonably incurred; and (3) the person must have acted honestly and in good faith with a view to promoting the best interests of the corporation.

The Deol Decision emphasizes the need for effective risk management by directors of corporations. This includes exercising effect due diligence in the operation and control of the corporation, as well as establishing and following policy statements and procedures. Effective due diligence includes having a good

knowledge of the governing documents of the charity, ensuring *ultra vires* acts are not authorized by the board of directors, ensuring effective management access and control over the affairs of the corporation, protection of the charity's assets, and developing and enforcing policies and procedures for staff, volunteers and board members. When in doubt as to the appropriate course of action, the board and/or individual directors should seek advice from their legal counsel.