

20 Questions Directors of Not-For-Profit Organizations Should Ask About **Fiduciary Duty**

Jane Burke-Robertson, B.SOC. SCI., LL.B.

How to use this publication

Each “20 Questions” publication is designed to be a concise, easy-to-read introduction to an issue of importance to directors. The question format reflects the oversight role of directors which includes asking a lot of questions.

The questions are intended to be relevant to most not-for-profit organizations. The “answers” or comments that accompany the questions summarize the legal background as well as current thinking on the issues and practices of not-for-profit governance. Examples and recommended practices are provided to help directors apply the information provided to their specific circumstances.

Readers who want more details on specific topics may refer to the section on “Where to Find More Information.” Most of the CICA 20 Questions series of publications for directors were written for business boards but are relevant to not-for-profit boards.

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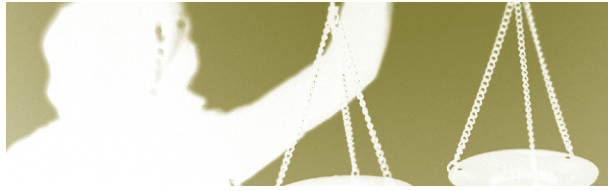
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Preface

The Risk Management and Governance Board of the Canadian Institute of Chartered Accountants (RMGB) has developed this briefing to help members of not-for-profit boards of directors understand and fulfill their fiduciary duties.

Directors of not-for-profit organizations in Canada are faced with a confusing array of duties and obligations, and yet successful fulfillment of their fiduciary role is critical both in terms of the wellbeing of the organization, and in order to protect themselves from liability.

Not-for-profit organizations are very diverse and range from small all-volunteer groups to large, sophisticated enterprises. This publication will focus on the fiduciary duties of directors of organizations in the corporate form, both those that are registered charities and those that are not.

The law on directors' duties is complex and this paper is a general overview of the subject. Directors should seek expert advice on particular issues as they arise.

The Risk Management and Governance Board acknowledges and thanks the members of the Not-for-Profit Organizations Task Force for their invaluable advice, Jane Burke-Robertson, who wrote this briefing under their guidance, and the CICA staff who provided support to the project.

Brian Ferguson, CA
Chair, Risk Management and Governance Board



Introduction

Directors of not-for-profit organizations have various duties and responsibilities. The most fundamental of these responsibilities is the duty of directors to act in the best interests of the organization they serve at all times, even at the expense of their own self-interest. This is known as a fiduciary duty.

The term “fiduciary” is a legal term intended to refer to a person who, because of the position they hold, has a responsibility to act primarily for another’s benefit. There are many different types of fiduciaries but this publication will focus on the role of directors as fiduciaries and the specific responsibilities involved.

Directors are sometimes referred to as the “directing mind” behind the organization they serve. Directors are the “public face” of an otherwise artificial structure. For this reason, the law and the public look to the directors to ensure accountability.

But where do these duties come from? Some of these duties and responsibilities are codified in written laws in the form of statutes, while others are not. Much of the material on this subject is part of the common law and is generated through court decisions. While the law varies to some degree across the country, the basic fiduciary duties of directors are substantially the same.

Many not-for-profit organizations are not incorporated. Some are established as trusts, while others exist as ‘unincorporated associations’. Whatever the title, and whatever the type of organization, there are some similarities with respect to the legal duties, responsibilities, and obligations of directors and trustees. However, there are some important differences as well, so it is advisable to understand the type of organization one is involved with.

What is a not-for-profit corporation? A corporation is an entity recognized by the law as having its own separate identity and it exists as a separate legal “person”. It is independent of the directors, officers, and members of the corporation and is responsible separately for its own debts and obligations. As such, the liability of directors, officers and members is limited by reason of the separate legal existence of the corporation. It is subject to written laws in the

form of corporations’ legislation.¹ This legislation also sets out certain duties, responsibilities and liabilities of the corporation’s directors. In the context of not-for-profits, corporations are incorporated as non-share corporations so that instead of shareholders, not-for-profit corporations have members.

What is an unincorporated association? An unincorporated association is a group of individuals that come together for a common purpose. The association has no legal identity separate from the people who make up the association. Unlike a corporation, there is no legislation governing unincorporated associations which provides legal protection to the individuals involved. Instead, individuals involved in unincorporated associations must rely on laws made by the courts. Often the individuals involved in an unincorporated association will write a contract (sometimes called a constitution) to set out how the organization is to be managed and/or operated. This does not create a separate identity for the association; but rather defines the legal relationship among the individuals (or members) of the association.

What is a trust? A trust is a type of legal relationship which is created when one or more persons holds legal title to property, but another person or persons has the right to the enjoyment or benefit from that property. Trusts are sometimes used for charitable purposes so that a group of persons (trustees) holds charitable property which must be used for charitable purposes (or public benefit). The powers and duties of the trustees are spelled out in the trust document and in provincial trustees’ legislation. Trustees are exposed to personal liability in the conduct of their position as trustees.

When getting involved with an organization, it is important to find out what type of organization it is. Ask the following preliminary questions:

- Is the organization incorporated? If not, what type of organization is it?

¹ See in Alberta *Societies Act* R.S.A. 2000 Chapter S-14, in British Columbia *Society Act*, R.S.B.C. 1996, c. 433, under federal jurisdiction, *Canada Corporations Act*, R.S.C. 1970, c. C-32, in Manitoba, *The Corporations Act*, R.S.M. 1987, C. C225, in New Brunswick, *Companies Act*, R.S.N.B. 1973, c. C-13, in Newfoundland *Corporations Act*, R.S.N.L. 1990, c. C-36, in Northwest Territories and Nunavut, *Societies Act*, R.S.N.W.T. 1988, c. S-11, in Nova Scotia, *Societies Act*, R.S.N.S. 1989, c. 435, in Ontario *Corporations Act*, R.S.O. 1990, c. C38, in Prince Edward Island, *Companies Act*, R.S.P.E.I. 1988, c. C-14, in Quebec, *Companies Act*, R.S.Q. 1977, c. C-38, in Saskatchewan, *The Non-profit Corporations Act*, 1995, S.S. 1995, c. N-4.2 and in the Yukon, *Societies Act*, R.S.Y. 2002, c. 206.

- If the organization is incorporated, under what jurisdiction? (i.e. Ontario, Saskatchewan, Canada, etc.)
- Can I review a copy of the legal documents setting up the organization, e.g. letters patent and by-laws?
- Is the organization a registered charity under the *Income Tax Act*?

The discussion that follows will focus on the fiduciary duties of directors of not-for-profit organizations, particularly organizations in the corporate form. While it will refer to some potential liabilities faced by directors of not-for-profit organizations, the liability of directors will not be the focus of this publication. The law on directors' duties is complex and this paper is a general overview of the subject. Directors should seek expert advice on particular issues as they arise.



1. What is the role of a director of a not-for-profit organization?

A director is a person who participates in the administration, guidance, and supervision of the affairs of an organization by being part of the governing body of the organization—the board of directors. A director, in the not-for-profit context, is one person in a collective body that governs the organization and provides strategic leadership for the organization. In most provinces and territories in Canada, a not-for-profit corporation must have at least three (3) directors. The title may not even be ‘director’. The title could be governor, trustee, or administrator.

In a small organization, the directors may not only set the direction for the organization, they may be involved in the day-to-day management of the organization. A director may also have separate roles as an officer and perhaps as a member of the organization.

Directors have an overall responsibility for the organization and the strategy for achieving its legal purpose. As a director, it is essential to understand why the organization exists, how it is legally structured, the interests of its stakeholders and how it manages the risks it faces. Directors should also be involved in the approval of, and at times the development of, the strategic plan.

FOR MORE INFORMATION SEE THE CICA PUBLICATION *20 QUESTIONS NOT-FOR-PROFIT DIRECTORS SHOULD ASK ABOUT GOVERNANCE*

Each province and territory in Canada has its own statute that sets out the rules that both the not-for-profit corporation and its directors must follow. The same is true for federal not-for-profit corporations. Similarly each jurisdiction also has its own ‘standard’ against which directors are judged. For example, in some provinces directors are held to the same standard (which is called an objective standard) while in others directors are judged against their own abilities, experience, and education (called the subjective standard). This can mean that some directors will be judged at a higher standard than other directors—within the same corporation and sitting on the same board of directors. This will be discussed below.

2. Are there different kinds of directors?

A “true” director of a not-for-profit organization is an individual who is elected or appointed to sit on the board of directors of the organization and who has full voting privileges as a director.

Individuals who sit on an advisory board, or who are *ex-officio* non-voting or honorary directors, are generally in a different legal position than “true” directors.

Ex-officio directors are individuals who qualify as board members by virtue of their office. In other words, the by-laws usually say that they are entitled to be directors by reason of holding some other office. Also, depending on the by-law, they may be voting or non-voting. An example of a by-law provision providing for an *ex-officio* non-voting director is:

The President of ABC Non-Profit corporation shall be entitled to be a non-voting director of XYZ Non-Profit Corporation, *ex-officio*.

An honorary director is often an individual who is given the title as appreciation for their service and is usually a non-voting director. An advisory board consists of individuals (often past directors) not actively involved with the organization but that provide advice to the board as needed.

Whatever title is given, technically speaking, a “director” who does not have voting privileges is not a director and does not have the same duties and responsibilities as a voting director. That said, if a non-voting director or other individual acts like a voting director, making decisions along with the rest of the board, there is a risk that he or she could be found by a court to be subject to the same fiduciary duties and other obligations as well as liabilities as an elected or appointed director.

A non-voting director is generally permitted to attend but not vote at board meetings, and may or may not be entitled to attend in-camera meetings of the board. However, if the limitations on the role, duties, and rights of a non-voting director are not clearly set out in the by-laws of the organization, *ex-officio*, honorary or advisory directors may be mistaken for full directors and run the risk of being treated by the courts as such should anything happen.

Example

Jasmine has spent many years volunteering on behalf of Small Town Ontario Figure Skating Club and has acquired a tremendous amount of knowledge about the organization. Jasmine does not want to be a director of the organization, so in appreciation for her many years of hard work, the organization suggests that Jasmine take the role of honorary director. She is invited to attend board meetings and provide her views on the matters the board must discuss – including the direction the skating club will take over the next several years. However, Jasmine is not entitled to vote on any matters discussed by the board.

Considerations: Do the by-laws of the organization provide for honorary directors? If so, are the duties of this role clearly set out? Could an outside observer mistake Jasmine for a “true” director and assume that she is a director like all the others?

Issue: Pierre and Manon collide at centre ice when each is practicing for an upcoming competition. Manon suffers a concussion and Pierre breaks his leg. Neither will be able to compete and will, arguably, not be spotted by the national coach looking for a new protégé.

Problem: If the by-laws of the organization do not clearly set out the rights and restrictions of an “honorary” director, there could be confusion about Jasmine’s role and even though neither she nor the organization intended for her to be a director, it could very well appear to others that she is a full director. If the organization and its directors are sued as a result of Pierre’s and Manon’s injuries, Jasmine may also be named as a defendant in the lawsuit.

3. What does an individual need to know before agreeing to become a director of a not-for-profit organization?²

Directors have various legal duties and obligations as well as liability risks associated with being a director. It is therefore important when thinking of becoming a director of an organization to consider a number of things. Asking the kinds of questions set out below will assist a potential director in acquiring the right kind of information about an organization before agreeing to become a director. Undertaking appropriate due diligence is an important part of agreeing to be a director and it will serve the organization well to understand the structure and other issues clearly. It is also important for a director to be knowledgeable in order to discharge the fiduciary obligations associated with being a director.

Think about the following issues and ask questions such as the following:

- What legal form does the organization take? Is it an unincorporated association? Is it a trust? Is it a corporation? It is important to be knowledgeable about the legal form of the organization.
- Is it a registered charity and if so, is its charitable registration in good standing? If the organization is a registered charity, it has additional and sometimes onerous compliance requirements under the *Income Tax Act* that directors should be aware of as a part of their duty of care and diligence.

Note: An organization could be incorporated as a not-for-profit organization with charitable purposes, but that does not mean that it is automatically a registered charity. Charitable registration takes 2 steps: first there must be an organization of some type, and second, that organization must apply for registration as a charity and must meet the criteria established in the *Income Tax Act* and through the courts in order to qualify as a charity.

Check the organization’s status as a charity at: <http://www.cra-arc.gc.ca>

- Does the organization have a board manual which you could review? Typically a board manual will include a copy of the letters

² Adapted from Chapter 1 of Industry Canada’s *Primer for Directors of Not-for-Profit Corporations*, listed in “Other Publications”.

patent, by-laws and operating policies and is a helpful resource.

- Is there a director code of conduct (usually includes a conflict of interest policy) which clearly outlines the expectations of the directors? This may or may not be part of a board manual.
- Is the mandate of the organization clear, i.e. why does it exist? What do the corporate objects say? Are its programs permitted by its objects? If the organization is carrying on programs that don't appear to be permitted by its objects, you could be exposing yourself to liability as a director.
- Where does the organization carry on its activities? If the organization carries on programs outside the country there could be additional compliance requirements.
- Do you have any existing conflicts of interest which could be problematic should you become a director? You should consider asking if there is an existing conflict of interest policy.
- Does the organization carry directors' and officers' liability insurance? This is an important consideration for most directors but it is also important to understand the kinds of things that are not covered by insurance.
- Does the organization have indemnification procedures in place for its directors? This would be in either the by-laws or policy and could entitle you to be indemnified in the event of a lawsuit involving the organization which names you personally. Some organizations are also prepared to provide directors with indemnification agreements which provides additional protection to directors (since by-laws and policy can be changed).

FOR MORE INFORMATION SEE THE CICA PUBLICATION *LIABILITY INDEMNIFICATION AND INSURANCE FOR DIRECTORS OF NOT-FOR-PROFIT ORGANIZATIONS*

- Ask questions about the structure of the organization, i.e. are there branches, chapters, and/or divisions? It is important to have an understanding of the size and structure of the organization.

- How many employees are there? Are there written contracts of employment with the organization?
- Is the organization up-to-date in the filing of its withholdings under the *Income Tax Act*? The organization has a duty to comply with statutory requirements under the *Income Tax Act* and the directors, as fiduciaries, must oversee its compliance. In addition, Subsection 227.1(1) of the *Income Tax Act* (Canada) imposes personal liability on directors for unremitted taxes. Directors of not-for-profit corporations must meet the same standard of care as their business counterparts if they want to avoid liability under subsection 227.1(1) of the *Income Tax Act*.

Depending on the information you obtain as a result of these inquiries, you may or may not agree to become a director of the organization you are considering. Don't be afraid to ask questions. Understanding the scope of an organization's activities and having a grasp on some of the important legal considerations is key to making a well-informed decision.

4. What is a "fiduciary"?

Directors of not-for-profit corporations are fiduciaries and are generally subject to the same common law fiduciary obligations as directors of business corporations.

A fiduciary is a person having a legal duty to act primarily for another person's benefit and is a person who (a) owes another person the duties of good faith, trust, confidence, and candor; and (b) must exercise a high standard of care in managing another's property. As a general matter, fiduciary duties are imposed by the law to protect those who are vulnerable from those who have power over them.

Why are directors in a fiduciary relationship? Because of the position they occupy within a corporation. The assets belong to the corporation which can only act through its directors.

Another example of a fiduciary relationship is a trust relationship. The trust property is held and owned by trustees who have complete control over it and the beneficiary is to all intents and purposes at the mercy of the trustees. The law

imposes a fiduciary duty on the trustees to safeguard the rights of the beneficiary.

Being a fiduciary means that directors will be held to high standards of good faith, fair dealing, and loyalty regarding the organization. The specific fiduciary duties are similar across corporate sectors (for-profit and not-for-profit) and have been imposed by statute in some Canadian jurisdictions. The standard of care against which directors' conduct is measured varies across the country.

5. What fiduciary duties do directors have?³

Directors' fiduciary duties can be divided into two main branches: the duty of care and duty of loyalty.

Duty of Care: Directors have a duty of competence i.e., a requirement to act with a certain level of skill. The duty of care describes the level of attention required of a director and can be described as a "duty to be informed" and to act with competence and diligence. A director must generally be informed about an issue before making a business decision relating to it. However, the law does not require directors to be experts but rather to act in accordance with a particular standard of care. The standard of care expected of directors is explained in questions 13 and 14.

It is also generally accepted that a heightened duty of care is owed by directors of a charitable not-for-profit corporation. For more information on the duty of care of directors of charities, see Question 14.

Duty of Loyalty: The duty of loyalty requires that a director act honestly and in good faith in the best interests of the organization. The duty of loyalty is a personal duty and cannot be delegated (the "no-delegation rule"). This means, among other things, that a director generally is not allowed to profit from his/her office and must avoid all situations in which his/her duty to the organization conflicts with his/her interests or duties to others (the "no-conflict" rule).

Example

A not-for-profit corporation's mandate is to work with underprivileged children. One of its projects is to sponsor underprivileged kids for summer camps. Scholarships are awarded to children who meet certain criteria developed by the board of directors. Gisele, a director on the board of directors, has a brother who has fallen on hard times and cannot afford to send his daughter to music camp this summer. Gisele's niece is a very talented pianist and the summer camp experience would help her improve her playing to the point where she might win a scholarship to university to study music. However, Gisele's niece does not meet the criteria for scholarships set by the board of directors.

Issue: Gisele could be in a conflict position. She has a fiduciary duty to the organization (a duty of care and a duty of loyalty). Even though she would prefer to recommend her niece for a scholarship, Gisele is required, by law, to do what is in the best interests of the not-for-profit corporation, rather than what is in the best interests of her niece.

Remember that directors retain many of their fiduciary duties even after they resign or retire. For example, competing with an organization for a lucrative contract which a director became aware of while on the board of an organization is a breach of the duty of loyalty. Similarly former directors should not disclose confidential information obtained while they were in office.

³ Adapted from Chapter 2 of Industry Canada's *Primer for Directors of Not-for-Profit Corporations*, listed in "Other Publications".

6. To whom are fiduciary duties owed?

It is important to keep in mind that directors owe a legal duty to the organization. Some people think that by joining the board of directors of an organization they will be in a position to help family and/or friends; however, they must keep the best interests of the organization ahead of their own personal interests or those of their family and friends at all times.

In a not-for-profit organization, the board of directors owes a fiduciary duty to the organization itself. Although directors are accountable to the members of the organization—the body who elected the directors and usually has the ability under the by-laws to remove the directors, directors do not owe the members a fiduciary duty. There are situations where the interests of the members and the interests of the organization are at odds and it is important to realize that directors' duty is to the organization, not to the members.

In a charitable organization, boards of directors are considered to have “trustee-like” attributes and they are subject to a fiduciary duty to act as a quasi-trustee of the general charitable property of the organization. These fiduciary duties are owed to the charitable purposes of the organization, the charity itself and some would argue even to its donors.

7. How can a director fulfill the duty of care?

The duty of care requires that directors pay attention and try to make good decisions for the organization.

This duty is comprised of the following responsibilities:

(a) The duty to act honestly

- Directors must deal honestly with the organization and not act for an improper purpose.
- Directors should also be candid about informing the chair if they can no longer afford the time commitment of being a director.

(b) The duty of diligence

- Directors must be diligent in attending to their legal duties. This is done by being familiar with the organization, being informed and by preparing for and attending meetings whenever possible.
- Where advice of a specialised nature is required, the board should obtain the services of qualified professionals.
- Directors should exercise their best judgment when voting on any decisions, and not simply vote with the majority for no well-informed reason.
- Directors must properly maintain minutes of the organization and ensure that all other corporate books and records are being maintained in proper order.

(c) The duty to exercise power

- Directors are ultimately responsible for the organization. Directors can breach their fiduciary duty through inaction and inattention. They are responsible for furthering the corporate goals and objectives. Directors must make decisions.
- Directors should develop standards for measuring performance of senior management and carry out annual performance reviews.
- In the case of a charity, funds received from the public for a specific charitable purpose must be held in trust for the charitable purpose and directors have an obligation to apply the funds or cause them to be applied in accordance with the charitable purpose.

(d) The duty of obedience

- Directors must comply with all applicable laws and the organization's governing documents (letters patent, by-laws etc.)
- Directors should ensure that corporate decisions are being implemented.



8. How can a director fulfill the duty of loyalty?⁴

The duty of loyalty is often considered the most important fiduciary duty and arises most often in the context of a conflict of interest. A conflict of interest can develop in two general ways:

- A personal conflict between the director's duty to act in the best interest of the organization and the director's own self-interest.

Example

- A director stands to gain financially from a proposed contract between the director (or his/her corporation or firm) and the organization; or
 - A director has a child, relative, or friend he/she would like to see benefit from the organization.
- A conflict of duties that the director owes to the organization he or she serves and to another organization.

Example

A director is the director of 2 corporations — and owes the same duty of loyalty to each — and the corporations are involved in one or more transactions.

The courts are very strict about the no-conflict rule as it relates to personal conflicts. Not only must a director avoid actual conflict, but also the appearance of conflict.

⁴ Adapted from Chapter 2 of Industry Canada's *Primer for Directors of Not-for-Profit Corporations*, listed in "Other Publications".

Fulfilling the duty seems simple enough:

1. Directors must act in the best interests of the organization and not their own interests; and
2. They must avoid situations in which they have competing fiduciary duties.

In other words, directors must not engage in transactions or conduct that creates a conflict between their duty to act in the best interests of the organization and their own personal interests — or the interests of another corporation to which they owe a fiduciary duty.

But not all situations in which directors find themselves are clear cut:

Many organizations have directors who are in a conflict of interest immediately upon their election or appointment as a result of an inherent conflict (such as being a beneficiary of the organization's programs). Some of these conflicts of interest are unavoidable where a specific board composition is considered desirable and especially where the perspective of certain types of directors is important to running the corporation's programs. For example, it is easy to see why it may be desirable for the board of a golf club to include directors who are members of the club or for the directors of a school for disabled children to include parents of children attending the school. That said, it is important to remember that a director has continuing fiduciary obligations to the organization they serve even outside of the confines of a board meeting.

In order to help avoid conflict of interest situations, or deal with conflicts as they arise, the following tips may be useful:

- Remind yourself of the reason you wanted to join the organization as a director.
- Ask yourself who you want to benefit: the organization or yourself, a family member or friend.
- Your primary duty is to the organization. If you are going to benefit in some way (either directly or indirectly), then you will likely be in a conflict situation.
- If the organization has a conflict of interest policy, review it on a regular basis, understand it, and apply it to the situations you face as they come up.

Note that if the organization is charity, it may be necessary to seek court approval to allow you to sit on the board of the charity where you also receive a direct or indirect benefit (see next question).

One might also argue that it is very difficult for directors to discharge some of their fiduciary obligations where directors sit as representative directors. For example:

Sitting as a “representative director”

A director sits on the board of a chapter of a national non-profit and also sits on the national board of directors. The board of the chapter considers that the director sits on the national board in a “representative” capacity. In other words that the director will further the chapter’s agenda. The director owes fiduciary duties to both the parent organization and the chapter organization and should declare a conflict where there are potential conflicts involving the two organizations. Where the chapter’s best interests are not necessarily aligned with those of national, the director will be in an untenable situation.

If you sit as a director of two “related” boards in an association structure, consider the following tips:

- Apply each organization’s conflict of interest policy to conflicts as they arise, which will likely involve declaring conflicts on a regular basis and abstaining from both discussion and voting with respect to various issues during the course of meetings.
- If being on two boards in a given organization results in continuing conflicts of interest both inside and outside the boardroom, consider speaking to the chair of each board to voice your concerns and if your concerns are not or cannot be addressed to your satisfaction, consider resigning from one or both boards.
- Consider whether there should be a review of the by-laws of either or both organizations where the related boards have few directors on the board without a conflict of interest. It may be time to change the board composition.

FOR MORE INFORMATION SEE THE CICA PUBLICATION *20 QUESTIONS DIRECTORS SHOULD ASK ABOUT CODES OF CONDUCT*

9. What should a director do if faced with a conflict of interest?

If faced with a potential conflict of interest, a director should:

- Immediately declare the conflict and abstain from voting where the conflict arises at a board meeting;
- Review the organization’s conflict of interest policy to determine if there are additional requirements imposed by the organization or whether there is an identified process which must be followed with respect to declaration of the conflict;
- Speak to the chair of the board or another officer identified by the conflict of interest policy concerning the nature of the conflict, particularly where the director is unsure if a conflict truly exists;
- If not a charity, look to the corporate legislation to determine if there is a declaration of conflict process which can be followed;
- Where the conflict places you in a situation in which you believe you cannot act in the best interests of the organization as a result of the conflict, resign;
- Where possible, avoid the potential conflict or where the conflict has already materialized, resign as a director if the organization is a charity and the director stands to benefit directly or indirectly.

Most non-profit corporate legislation in Canada provides for a narrow exception to the no-conflicts rule where a director has an interest in a contract or proposed contract with the organization, declares the conflict and follows the process outlined in the legislation⁵.

It is important to understand that this kind of statutory exception is not generally available

⁵ For example, section 98 of the *Canada Corporations Act* states that it is the duty of a director to declare an interest (whether direct or indirect) in a contract or proposed contract with the organization at a meeting of directors. The section contains specific requirements relating to timing and content of the declaration of interest and with limited exceptions, prohibits directors from voting on the contract or proposed contract in which the director is interested. The Act specifically provides that a director who has complied with the declaration of interest provisions is not accountable to the organization or its members by reason of the director’s fiduciary relationship for any profit realized by such contract and the director will escape any liability where the existence of the profit on the part of the director has been confirmed by the members of the corporation.

to directors of charities (as opposed to not-for-profits that are *not* charities), depending on the province in which the charity operates. Because of the premise that charities are there for the public good, directors of charities must avoid any interest in a contract unless court approval is given ahead of time.

10. How knowledgeable do directors have to be in order to discharge their duties?

The law does not require directors to be experts. While directors of not-for-profit organizations owe a duty of care, it is not realistic to expect directors to understand in detail all of the operations, laws and government policies affecting the organization. However directors should be well informed.

Examples

The organization has paid staff: Directors should know that there are employment laws, human rights laws, income tax laws, Canada Pension Plan and unemployment insurance laws affecting the organization and its relationship with employees and know when to seek legal advice.

The organization is an incorporated charity: Directors should be aware of applicable legislation governing the organization including income tax, corporate laws, trust laws, provincial charities and fundraising registration laws and at times provincial and federal lobbyist legislation. Directors should seek legal advice where needed.

The organization owns heritage property: Directors will need to understand what they are permitted to do with the property, within the province or territory (and usually within the city or town in which they are located).

The courts recognize that directors must be guided by what is referred to as a “business judgment rule”. The courts look to see that the directors made a reasonable decision, not a perfect decision. In coming to a decision, directors must show that they acted prudently and on a reasonably informed basis.⁶

As a result, directors should:

- have a general knowledge of what laws affect the type of organization, and
- inform themselves about the governance model of the organization, the structure of the organization, what the organization does, how it does it and who its beneficiaries are.

The following guidelines have been established by the courts:

- Directors are not liable for mere errors of judgment;
- 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 to discharge their fiduciary obligations;
- Directors may entrust certain matters of business to officers of the organization; and
- Directors are justified, in the absence of grounds for suspicion, in trusting that officers of the company will perform in their duties honestly.⁷

⁶ *Peoples Department Stores Inc. (Trustee of) v. Wise* [2004] 3 S.C.R. 461, 2004 SCC 68

⁷ *Re City Equitable Fire Insurance Company Limited* [1925] 40 ChD 41

11. What if directors permit the organization to act outside the scope of its authority?

In addition to the statutory powers set out in the corporate legislation, a not-for-profit organization is only allowed to carry on those activities and do those things that are set out in its objects described in its letters patent. Objects are essentially corporate “purposes” and set out a list of things that the organization can do. Directors have a fiduciary obligation to safeguard the organization’s corporate objects and to make sure that the organization’s activities and programs are permitted by its objects.

If directors cause or permit the organization to act outside the corporate objects, then the actions taken by the directors are void and “*ultra vires*” and the directors may be held personally liable for any loss or damage that results from such action.

Example

The letters patent of a not-for-profit corporation state that the corporation’s object is to relieve poverty by gathering and distributing used clothing to the homeless in Ottawa. The corporation applies for charitable status and is approved. Some time later, the directors realize that what is really needed in the area are soup kitchens as winter is fast approaching and people need food as much as they need clothing.

Unless the corporation amends its letters patent to add a soup kitchen program as an object of the corporation, it is not allowed to do so. This is called “acting outside the corporate objects and powers”.

To avoid a situation like this, it is important to review the organization’s objects and statutory powers on a regular basis and in particular when discussing programs an organization wants to provide to determine whether or not the organization is actually allowed to undertake such a program.

12. Can directors of charities receive remuneration or other benefits?

This question is a common one and is not easily answered.

Depending on the province in which the organization operates and on whether the organization is a charity, the duty of loyalty and the no-conflict rule may prohibit directors from receiving any direct or indirect benefit from the organization.

The issue can come up for directors of charities in different ways:

Examples

The founder of a charity is also a director and as the charity grows, the founder becomes a paid executive director.

An organization’s by-laws provide for a beneficiary of the organization (a person receiving benefits or services from the organization) to sit as a director.

A particular organization requires its directors to travel significantly in order to attend board meetings which are held on a frequent basis. The board wishes to pay a small honorarium or stipend to its directors due to the level of involvement and time required.

An organization develops a practice over time that the chief staff person will be a member of the board of directors.

Leaving aside any conflict issues that these arrangements could involve, the question of whether the director can receive any benefit will depend on the province in which the organization operates. For example, in Ontario directors of charities are prohibited from receiving remuneration or other benefits whether directly or indirectly. In limited circumstances it can be possible at times to obtain a court order authorising the payment of remuneration to a particular director. But it should be emphasised that these cases are rare. Legal advice is generally recommended.

It is important to understand that while tax⁸ and corporate statutes⁹ do not generally prohibit directors of charities from being paid, the common law and in some cases provincial trust laws may prohibit payment to a director without a court order. To complicate matters further, an organization may be considered to be charitable at common law but not be registered federally as a charity under the *Income Tax Act*.

Note that there is generally no such prohibition on directors of not-for-profit organizations (that are not charitable at common law – as opposed to being registered charities under the *Income Tax Act*) who can usually receive remuneration and/or other benefits from the organization they serve.

Example

André is a director of a charitable organization whose mission is to relieve poverty in Africa by providing food, housing, and marketable skills to those in need. The organization is incorporated in Ontario and has its head office address in Ontario. André spends most of his time in Africa working with the local population to carry out the charity's mission. André has no source of income. The charity pays him a stipend which covers his travel, accommodation, food and clothing.

In Ontario, André would be required to either (a) resign from the board of directors, or (b) obtain court approval in order to remain a director while being paid by the charity. In other jurisdictions in Canada, André may be able to be paid by the charity, without any restrictions. Professional advice is recommended before paying directors of charities.

Remember that there is a difference between being paid by the organization and being reimbursed for legitimate out-of-pocket expenses incurred. Directors are almost always entitled to be reimbursed for out-of-pocket expenses subject to any provision to the contrary in the by-laws or operating policies of the organization.

⁸ The guideline used by Canada Revenue Agency is "reasonableness".

⁹ Some non-profit corporate statutes (e.g. Ontario and Saskatchewan) specifically allow directors to receive reasonable remuneration. But directors of charities are also subject to the common law and provincial trust laws.

13. What does it mean to have a "standard of care"?

Directors must carry out their obligations with an appropriate degree of skill and care and in accordance with the relevant "standard of care". Directors may incur liability where their conduct falls short of the prescribed standard of care.

The standard of care for directors of not-for-profit corporations varies across the country. In some provinces and territories, the incorporating statute is silent as to the relevant standard and the common law subjective standard applies.¹⁰ In others, the statutes explicitly provide for an objective standard.¹¹

What is the difference between a subjective and objective standard of care?

The objective standard judges all directors against the same criteria. Directors are required to exercise the degree of care and skill of a "reasonably prudent person".

The subjective standard judges directors against their own personal characteristics, attributes, skill level, education, experience, and profession. Directors are required to exercise the degree of care and skill that may reasonably be expected of a person of the director's particular knowledge and experience. The more sophisticated the director, the greater care he or she must exercise. As a result, if a director is a professional such as a lawyer or accountant, the law expects the director to apply that expertise in the individual's role as a director and the director will be held to a higher standard. Likewise a director with sophistication in running a business or other organization, whether or not he or she also carries a professional designation, will also be held to a higher expectation.

It is recommended that prospective directors familiarize themselves with the applicable standard of care to be exercised in carrying out their duties since there is a risk to directors who do not pay attention to the affairs of the organization they serve.

¹⁰ This is the case in Alberta, New Brunswick, Nova Scotia, Nunavut, Ontario, Prince Edward Island, Quebec and the Yukon.

¹¹ This is the case in British Columbia, Manitoba, Newfoundland and Saskatchewan.

14. Are directors of charities held to a higher standard of care?¹²

Where a not-for-profit organization is also charitable (either a registered charity or charitable according to provincial case law), board members may be required to meet additional expectations — and a higher standard of care. This is especially true when the organization carries on all or some of its activities in the province of Ontario.¹³ Ontario charities legislation specifically characterizes the legal nature of a charitable corporation as that of a trustee and Ontario case law has determined that directors of charities “are, to all intents and purposes, bound by the rules which affect trustees”.¹⁴

This means that they must take pro-active steps to protect charitable property. Any loss of charitable assets due to the inactivity or failure to act of the directors could make the directors liable for breach of their fiduciary duties, or possibly even breach of trust.

While the law is not uniform or even settled on this point across the country, it is prudent for directors of charities to carry out their duties as though they have charge of property that is subject to a trust. This “trustee standard” is generally considered a more demanding standard in law, and goes beyond what is ordinarily expected of either a not-for-profit or a for-profit director. This standard requires directors to exercise the degree of skill and prudence comparable to a reasonable and prudent person in the management of his or her own affairs. Under this standard, directors of charities must maintain the trust property or cause it to be maintained and are responsible for making prudent and safe investment decisions, subject to any requirements of provincial trust statutes.

From a practical perspective, this means that directors of charities should pay close attention to risk management issues affecting the organization especially as they pertain to the organization’s finances. In particular, directors should require regular financial reporting especially with regard to donations received, terms or conditions attached to donations and as well as ensuring the proper application of restricted donations and

¹² Adapted from Chapter 2 of Industry Canada’s *Primer for Directors of Not-for-Profit Corporations*, listed in “Other Publications”.

¹³ *Charities Accounting Act*, R.S.O. 1990, c. C10 Section 1(2)

¹⁴ *Ontario (Public Guardian and Trustee) v. Aids Society for Children (Ontario)* 39 E.T.R. (2d) 96.

investment of the organization’s funds. Directors of charities should also ensure that the organization develops and maintains an investment policy which is in accordance with applicable legal requirements.

15. What duties do directors of charities have with regard to special purpose or restricted gifts?

Fundraising is important to most charities. Whether the fundraiser is a walk-a-thon, a read-a-thon, a door-to-door canvas or a gift through an estate, directors of charities must pay attention to the way in which a charity fundraises¹⁵, how the money is used, how it is accounted for and reported to Canada Revenue Agency¹⁶ and how it is receipted by the organization¹⁷.

In addition, directors of charities have a legal duty to apply special purpose or restricted gifts to the purpose specified by the donor. If they fail to do so, directors may face personal liability. The heightened duty of care of directors of charities referred to in Question 14 is applicable to directors who manage property that is subject to a trust.

Examples

- A charity completes a fundraising drive, the purpose of which is to raise funds for a particular educational conference. The fundraising material tells prospective donors that their gifts will be used to hold the conference.
- June Bukowski leaves \$10,000.00 in her Will to the Anytown School with instructions that the money is to be used for the charity’s reading program offered specifically to special needs children.

In both of the above examples, a trust may be created (called a special purpose charitable trust) and the money received by the charity through the fundraising drive or under the will must be used for the specific charitable purpose. Note

¹⁵ The provinces of Alberta, Saskatchewan, Manitoba and PEI all have fundraising registration requirements for charities or fundraising companies working for charities.

¹⁶ Canada Revenue Agency has released a draft policy on fundraising and is undergoing a public consultation on the proposed draft. The purpose of the draft policy is to provide information for registered charities on the treatment of fundraising under the *Income Tax Act*.

¹⁷ The *Income Tax Act* and Canada Revenue Agency policy has strict rules on the receipting of gifts by registered charities.

that the terms attached to the charitable trust may be created by the charity or by the donor. The overriding duty of the directors is to carry out any restrictions attached to a special purpose charitable trust. Directors may be found in breach of trust if they do not comply with the terms of a special purpose charitable trust, meaning that they could be found personally liable if the terms of the trust are not complied with.

Directors should:

- Be aware of the terms of any special purpose trust funds and comply with those terms;
- Oversee the organization's fundraising program so that they are aware of the fundraising methods being used by staff or professional fundraisers that may result in a special purpose trust fund being created;
- Where the terms of any special purpose trust are no longer capable of being fulfilled by the charity, apply for a court order to vary the terms of the trust.

16. What if a director breaches his or her fiduciary duty?¹⁸

Directors who breach their fiduciary duties are at risk of being found personally liable if the organization suffers a loss which can be attributed to the actions or omissions of the directors.

If a director breaches his/her fiduciary duty, in order to be held liable (and to pay damages), the breach has to result in a loss which can be traced back to the individual director. In the case of a charitable organization, the loss could be to charitable property comprising a special purpose charitable trust. For example, directors could be held personally liable for breach of trust if they mismanage the charity's assets — meaning that they can be personally responsible for the full amount of any loss to the charitable assets.

In each case, liability will depend upon the particular facts and circumstances at play and legal advice is critical.

¹⁸ Adapted from Chapters 2 and 3 of Industry Canada's *Primer for Directors of Not-for-Profit Corporations*, listed in "Other Publications".

- To protect themselves from liability, directors should always consider whether the decision(s) or action(s) being taken are in the best interests of the organization.
- They must discharge their duties of skill and diligence, as well their duty of loyalty, including acting honestly and in good faith, not improperly delegating their responsibilities, and avoiding conflicts of interest.

It should be noted that the organization's indemnification by-law or policy on indemnification may not be available to directors who have breached their fiduciary duty and insurance coverage may similarly not be available.

17. As fiduciaries, can directors delegate their authority and/or their responsibility?¹⁹

Directors are entitled to delegate the performance of some of their responsibilities to committees, officers, or even members of the organization. However, directors should be aware that even though they may have delegated a particular task, delegation does not relieve them of responsibility. They must continue to monitor performance.

In Québec, directors of *Companies Act* corporations may not delegate powers to any committee other than an executive committee composed exclusively of directors and created by a by-law adopted by 2/3 of the members present at a special meeting.

Wholesale delegation is never permitted and a director cannot delegate all of his/her responsibilities as a director to another person. The reason: wholesale delegation would usurp the role of the organization's members in electing directors.

If it is intended to delegate core responsibilities, it is wise to set out such delegation in the by-laws or policy of the organization that has been approved by resolution. The scope of delegation, the duration of the delegation, the requirements for reporting back to the full board, and the relationship between the board and the body to which the matter is delegated should be included. Further, such delegation should ideally only be made to a board committee authorized by the by-laws.

¹⁹ Adapted from Chapter 2 of Industry Canada's *Primer for Directors of Not-for-Profit Corporations*, listed in "Other Publications".

Where directors of charitable organizations may be considered to be trustees, their ability to delegate decisions with respect to treatment of charitable property may be even more constrained. At common law, trustees are not allowed to delegate these types of decisions. However, provincial legislation governing trustees should be consulted to determine if such legislation permits some delegation by trustees. The following are examples of both permitted delegation and non-permitted delegation:

Example #1: Permitted Delegation

The directors hire an executive director. The executive director runs the day-to-day activities of the organization and reports to the board of directors at each meeting of the board. Day-to-day activities include hiring and supervising the office staff and volunteers, running programs, arranging board meetings, etc.

Example #2: Non-permitted Delegation

The directors hire an executive director and delegate all responsibilities of the organization to the executive director. The executive director purchases a building, sets his/her own salary, and files an application for supplementary letters patent to change the objects of the organization. None of these matters may be delegated by the directors.

18. What if a director disagrees with the decision taken by the rest of the board?

It is important to remember that a decision made by the board of directors, whether a majority, two-thirds or some other level of decision-making, means that the board has spoken on behalf of the organization. Every director is responsible for the decision, whether or not the director is present at the meeting. It also means that every director is jointly and severally liable along with the remaining directors should a loss occur as a result of the decision.

What can a director do?

If a director disagrees with a decision, silence is never a prudent course. It is important for a director who disagrees with a decision made by the board to voice his or her objection at the meeting and to ensure that his or her dissent is recorded in the minutes of the meeting, preferably with

reasons. Follow up to ensure that the minutes properly record the dissent should be done at the beginning of the next board meeting. A properly recorded dissent may, depending on the circumstances, result in the director limiting his or her personal liability. In addition to discharging the duty of diligence, attendance at board meetings can be helpful in limiting director liability in certain instances and provided appropriate steps are taken when the director disagrees with the rest of the board.

If a director is unable to attend a meeting, obtain copies of the minutes and any materials considered at the meeting. Read the minutes and be sure to immediately state any objection you may have in writing in the form of a written dissent to the secretary or chair of the board.

If a director is concerned about liability, independent legal advice should be sought.



19. When should a director seek independent legal advice?

When a director retains a lawyer to provide advice which is paid for by the director personally, he or she is seeking independent legal advice—that is, independent from the organization and the board.

Disputes and disagreements among directors can arise. A director may disagree with the direction

the organization is going in and may be a minority voice on the board. At other times, the board may not function effectively and a director may feel that he or she cannot fulfill his or her fiduciary duties for a variety of reasons. While it may be sufficient in order to limit liability to require that the organization record the director's dissent in the minutes of a board meeting, there are times when a director may need specific legal direction—usually in order to minimize his or her exposure to liability.

While there are any number of instances in which independent legal advice may be advisable to obtain, as a general rule if a director feels he or she cannot properly discharge his or fiduciary obligations for any reason or if a director considers that he or she may have personal liability, the director should seek independent legal advice.

The following examples may assist in determining when a director of a not-for-profit organization should consider obtaining independent legal advice:

- A director believes that a particular program may not be permitted by the organization's objects and the board has decided not to seek legal advice concerning this issue;
- A director is concerned about a particular issue or matter involving the organization and does not feel that his or her concerns have been properly answered or addressed by the board or the chief staff person;
- A director believes that the board may be found negligent as a result of particular decision or omission;
- A director considers that several board members have an insurmountable conflict of interest regarding a particular matter which is being ignored by the board as a whole;
- A director is unable to obtain certain financial or other information concerning the organization from the board and staff and the director is concerned about meeting his or her fiduciary obligations;
- A director is concerned about his or her personal liability regarding an ongoing program and requires advice concerning the effects of his or her resignation;
- The organization is insolvent and the director wishes to determine if he or she will have liability for debts of the organization, particularly those involving employees and taxes.

20. What tools can be used by directors to assist them in discharging their duties?

Directors have many tools available to them in order to discharge their fiduciary duties. The following are helpful, particularly to new directors:

Board manuals including the following items:

- The letters patent and supplementary letters patent of the organization;
- Current by-laws of the organization;
- Code of conduct for directors;
- Financial information;
- Charitable registration information;
- Minutes of meetings;

Board policies (which may also be included in board manuals) such as:

- Conflict of interest;
- Risk management;
- Fundraising;
- Personnel;
- Corporate audit policies.

Educational sessions on subjects such as corporate governance, corporate audits and risk management can be very enriching and informative for boards. As well, board retreats allow directors, and often the senior staff, to get together for an extended period of time to review the vision, mission and/or strategic plan of the organization without outside distractions.

Professional assistance is a key tool which should be used by boards in discharging their fiduciary duties. It is important for boards to seek professional advice for various matters including, legal issues, accounting issues, investment advice, etc. An organization should not hesitate to call in professional help as needed and should include an amount for professional assistance in the organization's budget.

When in doubt, a director should not hesitate to ask the chair or senior paid staff for the information that they need in order to fulfill the duties associated with their position. While charities and non-profit organizations will be at various stages in their organizational development and some may not have board manuals and well developed policies, it often takes just one motivated director to bring these tools into existence for the benefit of future boards.



Where to find more information

CICA Publications on governance

THE 20 QUESTIONS SERIES*

- 20 Questions Directors and Audit Committees Should Ask about IFRS Conversions
- 20 Questions Directors Should Ask about Building a Board
- 20 Questions Directors Should Ask about CEO Succession
- 20 Questions Directors Should Ask about Codes of Conduct
- 20 Questions Directors Should Ask about Crisis Management
- 20 Questions Directors Should Ask about Crown Corporation Governance
- 20 Questions Directors Should Ask about Director Compensation
- 20 Questions Directors Should Ask about Directors' and Officers' Liability Indemnification and Insurance
- 20 Questions Directors Should Ask about Executive Compensation
- 20 Questions Directors Should Ask about Governance Assessments
- 20 Questions Directors Should Ask about Internal Audit (2nd ed)
- 20 Questions Directors Should Ask about IT
- 20 Questions Directors Should Ask about Management's Discussion and Analysis (2nd ed)
- 20 Questions Directors Should Ask about Responding to Allegations of Corporate Wrongdoing
- 20 Questions Directors Should Ask about Risk (2nd ed)
- 20 Questions Directors Should Ask about their Role in Pension Governance
- 20 Questions Directors Should Ask about Special Committees
- 20 Questions Directors Should Ask about Strategy (2nd ed)

THE CFO SERIES*

- Deciding to Go Public: What CFOs Need to Know
- Financial Aspects of Governance: What Boards Should Expect from CFOs
- How CFOs are Adapting to Today's Realities
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20 Questions Directors of Not-for-profit Organizations Should Ask about Risk

20 Questions Directors of Not-for-profit Organizations Should Ask about Strategy and Planning

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Internal Control 2006: The Next Wave of Certification — Guidance for Directors

Internal Control 2006: The Next Wave of Certification — Guidance for Management

Understanding Disclosure Controls and Procedures: Helping CEOs and CFOs Respond to the Need for Better Disclosure

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*Available for purchase in hard copy or free download at www.rmgb.ca

WEBSITES

Alliance for Nonprofit Management, Washington, DC www.allianceonline.org

Altruvest Charitable Services www.altruvest.org

Canadian Society of Association Executives www.csae.com

The Charity Commission for England and Wales, Charities and Risk Management, 2007.
<http://www.charity-commission.gov.uk/investigations/charrisk.asp>

Charity Village www.charityvillage.ca

Imagine Canada www.imaginecanada.ca

United Way of Canada: Board Development www.boarddevelopment.org

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Jane Burke-Robertson practices in the area of charity and not-for-profit law. Ms. Burke-Robertson has consistently been recognized as a leading expert in charity and not-for-profit law by Lexpert and The Best Lawyers in Canada.

Primarily advising charities and not-for-profit organizations, Ms. Burke-Robertson's practice includes registration of charities under the *Income Tax Act*, international agency relationships and charitable joint ventures, affiliation agreements, strategic alliances, foundations and other vehicles for fundraising purposes, issues related to special act corporations and various other types of not-for-profit corporations. She is also highly experienced in dealing with membership disputes, board and membership control issues, structural considerations in national and international charitable and not-for-profit organizations, mergers, amalgamations and continuances.

Ms. Burke-Robertson is co-author of *Non-Share Capital Corporations* published by Carswell. She is also a contributor to Industry Canada's *Primer for Directors of Not-for-Profit Corporations*, published in 2002. Ms. Burke-Robertson is a frequent speaker and lecturer on charitable and not-for-profit matters and has written extensively in this subject area. Ms. Burke-Robertson recently taught an advanced seminar on the law of charities and non-profit organizations at the Faculty of Law, University of Ottawa.



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