The Responsibilities and Liabilities of Foundation Directors and Trustees*

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I. Introduction

A. Overview

Outside the realm of the law of charities there are significant differences between the responsibilities placed upon trustees and those placed upon directors of corporations. Trustees are held to the most rigid standards of fiduciary conduct while directors of corporations, also fiduciaries in the strictest sense, are not held to the same high standards. Until recently it was believed that this distinction held true, albeit to a lesser extent, for directors of charitable organizations. Indeed, many charitable organizations were set up as societies or nonprofit corporations rather than as trusts on the assumption that the duties and liabilities of directors of the former were less onerous than those of trustees. There is now, however, some argument as to the validity of this assumption.[1]

This article will discuss the duties and liabilities of directors of charitable organizations. It will show that while there may be different statutory provisions and common-law rules creating the duties and liabilities applicable to trustees on the one hand, and directors of corporations on the other hand, within the context of charitable organizations those duties and liabilities tend to merge and to become closer to those of the trustees of a charity.

The nature of the responsibilities (and the consequent potential liability) that the directors of a charitable organization bear is, in the first instance, directly related to the vehicle which is selected for the organization to carry on its operations. The three vehicles which can be used for charitable purposes are: 1) an unincorporated association, 2) a trust, or 3) a federal or provincial nonprofit corporation or society. Individuals operating a charity as an unincorporated association will be personally liable for all their own transactions because the unincorporated association is not separable from the individuals

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who comprise it. Consequently, most charities are operated as either trusts, societies, or corporations.

A society, at least in British Columbia, is simply a provincial nonprofit corporation. "Society" is the name that the provincial statute gives to such an incorporated entity. In some other provinces, and federally, an incorporated nonprofit entity is called, less confusingly, a nonprofit corporation. In the same vein, the board members of a charity set up as a trust will be trustees and those of a charity set up as a charitable corporation or society will be directors. The specific name given to the board member is of no consequence: a "board of governors" of a trust, for example, will still constitute a board of trustees at law regardless of its title.

B. *Trustees or Directors?*

There has been a trend over the last few decades for courts to apply "the same rules which affect trustees" to directors of charitable societies and corporations. This trend has accelerated in recent years, producing some uncertainty about the extent of its application.

The first Canadian case to have substantial impact in this regard was *Re Public Trustee and Toronto Human Society et al.*[2] decided in Ontario in 1987. This case dealt with an application contesting the validity of various actions of the Society and its directors which developed out of a fierce internal political dispute within the Society. The major point of contention was the extent of the Society's support of a group who wished to abolish the statutorily sanctioned practice of providing impounded animals for scientific research. In reviewing the application, the Court had cause to consider the question of whether the Society and its directors should be treated in a manner analogous to a trust and its trustees. The Court reviewed the provisions of the *Charities Accounting Act*[3] of Ontario (there is no equivalent in British Columbia). This *Act* deems a society to be a trustee for certain purposes. The Court ultimately decided that the Society and its directors were answerable as if the Society were a trustee under the *Act* and under the inherent supervisory and equitable jurisdiction over charities. The Court also found that the whole structure of the charity partook sufficiently of a trust so as to make it amenable to direction under the *Trustee Act.* While this reasoning does not mean that the directors are trustees, it ends up imposing, essentially, all responsibilities of a trustee on the directors of a society.

Similar reasoning was also applied in *Harold G. Fox Education Fund* v. *Public Trustee*[4], a more recent case, where the question arose as to whether the directors of a charitable society could be compensated for services other than those associated with their services as directors. The Court reviewed both the *Corporations Act* and the *Trustee Act* of Ontario and analyzed the situation

applying principles of trust law as well as of corporate law. The Court explicitly stated that it was proceeding "in this application on the ground that the activity of the applicant is a charitable trust"[5].

Even though these cases are from Ontario where the *Charities Accounting Act* treats charitable corporations as trustees for certain purposes, the courts in that province are proceeding to apply other statutes and the common law on the basis that charitable societies are analogous to charitable trusts. Furthermore, in a somewhat contentious move, the Public Trustee of Ontario considers that directors in that province are either "settlors" or "trustees" of any property that the charitable organization holds and that they must administer the property on behalf of the "beneficiary" as described in the objects clauses of the company's incorporation documents.[6]

The trust analogy may ring true for the basic standards of fiduciary conduct expected of one who is administering property for a charitable purpose. The analogy breaks down, however, if taken too far. Trustees must act unanimously unless otherwise empowered. Conversely, the default position for directors is that they need not act unanimously. Trustees are liable if they neglect to take part in decisions, merely "rubber stamping" those made by their fellow trustees. Directors of companies, on the other hand, generally would not be liable at common law if they missed a meeting at which decisions were made which subsequently produced liability[7]. In addition, trustees can rely on s.98 of the *Trustee Act* which may excuse them from liability if they acted "honestly and reasonably". There is no equivalent provision for directors.

II. Contrasting Responsibilities of Directors and Trustees

As discussed above, it now seems likely that directors of charitable corporations will be held to the same high standards of conduct and responsibility as trustees in most matters. Nevertheless, because there are certain important differences in both the common law and the statutory provisions that apply to the two groups, the applicable law will not necessarily be the same in all situations. Unfortunately, due to the number of potentially applicable standards (common-law standards for directors; common-law standards for trustees; statutory standards for directors; and statutory standards for trustees), guidance for the concerned director is not easily available from one source. An examination of a number of these standards will illustrate the difficulty.

A. *Standard of Care*

1. Common Law

The generally accepted standard has been that of an ordinary man of prudence who is managing his own affairs. This test gained most of its authority from the Supreme Court of Canada decision in *Fales* v. *Canada Permanent Trust*

Co.[8] There has been some indication in recent cases, however, that the test is becoming stricter. This is almost certainly true when it comes to investing trust property.

In the British case, *Cowan* v. *Scargill,*[9] a stricter test was adopted so that a trustee, at least when exercising powers of investment and perhaps more generally, must "take such care as an ordinary prudent man would take if he were minded to make an investment *for the benefit of other people for whom he felt morally bound to provide* (emphasis added).[10] This test dates back to the old House of Lords case, *Learoyd* v. *Whiteley,*[11] where Lord Watson said:

> As a general rule, the law requires of a trustee no higher degree of diligence in the execution of his office than a man of ordinary prudence would exercise in the management of his own private affairs. Yet he is not allowed the same discretion in investing the moneys of the trust as if he were a person *sui juris* dealing with his own estate.

Below, in the Court of Appeal, Lindley L.J. had actually formulated the *Cowan* test when he said:[12]

> The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.

This test would appear to be considerably more stringent than the one advanced in *Fales*.

While the *Cowan* decision has not been explicitly followed in Canada (at least with respect to the more stringent standard of care), trustees should be aware that the trend over the last few years has been for courts to impose stricter and stricter standards on their actions. The *Cowan* test is also discussed with approval in Waters' *The Law of Trusts in Canada,*[13] the leading Canadian text on trusts.

At one time, there had been some doubt as to which of these tests was the correct one for application in Canada.[14] Most lawyers practising in the areas of pensions and charities have now accepted that the test put forward in *Cowan* is, if not the right one, certainly the most prudent one to adopt. Lawyers who are advising pension plans should certainly be advising pension trustees and administrators to assume that the more stringent standard applies. In most situations the analogy between behaviour for fiduciaries with respect to pension plans and charities will hold true. Consequently, whether the fiduciary of a charitable foundation is a director or a trustee, he or she should assume that the *Cowan* test applies to regulate the fiduciary's behaviour.

2. Statutory

Section 25 of the *Society Act*[15] of British Columbia provides a statutory standard of care which is indicated to be in addition to any other duties that are applicable. The section provides as follows:

> (1) A director of a Society shall
> (a) act honestly and in good faith and in the best interests of the Society;
> (b) exercise the care, diligence and skill of a reasonably prudent person, in exercising his powers and performing his functions as director.
> (2) The requirements of this section are in addition to, and not in derogation of, an enactment or rule of law or equity relating to the duties or liabilities of directors of a society.

Immunity from these duties is restricted by s.26 which states:

> Nothing in a contract, the constitution or the bylaws, or the circumstances of his appointment, relieves a director
> (a) from the duty to act in accordance with this *Act* and the regulations; or
> (b) from a liability that by virtue of a rule of law would otherwise attach to him in respect of negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the Society.

It should be noted that the standard of care applied by the statute in section 25(1)(b) would seem to be comparable to the old *Fales* test rather than the newer test from *Cowan*. As a result, it may well be that the common-law standard of care significantly exceeds the provincial statutory standard. Because section 26 specifically indicates that the statutory standards do not derogate from any applicable common-law standards, the stricter standard will apply. Directors should be aware of this discrepancy and make sure that they do not take comfort from the lesser statutory standards which are probably outdated.

In addition, it is arguable that the doctrine of *ultra vires* still applies to charitable societies incorporated under the *Society Act.*[16] While the doctrine was abolished for corporations incorporated under the *Company Act*, it would seemingly still apply to societies incorporated under the *Society Act* by virtue of sections 4(1)(d) and 32(1). These sections provide some potentially serious headaches for charitable corporations since they restrict effectively the activities of a society to only those purposes which are permitted by its constitution and by the statute. If a society should stray outside the bounds of its permitted purposes, it is acting unlawfully. The common-law doctrine of *ultra vires* does not allow liability protection for directors of a company who authorize activities which are *ultra vires* the company.

Societies should be particularly careful to operate within their stated purposes in the following areas:

a) Vague purpose clauses are often relied upon to accommodate changes in the society's directions—such clauses may not properly authorize all activities that the society is involved in;

b) Political activities, whether they are permitted by Revenue Canada or not, and other noncharitable activities will usually not be authorized by the society's purpose clauses;

c) Carrying on business incidental to charitable purposes[17] should be watched carefully—if the business activity becomes too consuming, it will be *ultra vires*; and

d) Many societies have inadequate borrowing and investment powers—such powers are severely restricted by the *Act* unless specific powers are in the bylaws.

The general standard of care described above extends to all aspects of a charity's operations. There is an additional interesting point with respect to the standard of care involved in the selection of beneficiaries.

While many bequests to foundations are made without "strings attached" to them, some come with directions as to the use that the donor wishes the foundation to make of the funds. In many cases, these deeds of gift will specify a large stable beneficiary such as the United Way or British Columbia's Children's Hospital. Occasionally, however, a foundation may be unable to carry out the wishes of the donor because the recipient organization has ceased to exist. If this happens and there are no alternative beneficiaries specified in the deed of gift, the foundation will be forced to make what is known as *cy-près* application to court in order to select a similar charity with similar objects as the replacement beneficiary. Obviously, the time and expense involved in such applications are undesirable and, if possible, the directors or trustees, as the case may be, should insist on alternative beneficiaries for deeds of gift which incorporate specific directions.

B. Delegation

1. Common Law

The general rule is that a trustee is not permitted to delegate the tasks associated with the office of trustee. Over the years, however, the common law has recognized that it is prudent, if not essential, for a trustee to delegate certain tasks which will be better and more efficiently performed by agents. Trustees may now hire lawyers, brokers, accountants, real estate appraisers, investment managers, etc. if it can be established that a reasonably prudent businessperson

would hire such agents in a similar situation.[18] It is essential, however, that the trustee exhibit a proper level of supervision and consideration in the hiring. What constitutes the proper level of supervision and consideration will vary depending upon the position involved and the skill and responsibility associated with it.

Normally, if the trustee follows the "usual practices of business" in the selection and supervision of the agent, no personal liability will attach to the trustee if the agent later absconds with trust property or otherwise creates liability for the trust.[19] However, a recent decision of the British Columbia Supreme Court in *Bentley* v. *Canada Trust*[20] indicates that following the usual "practice in the industry" will not shield a trustee from liability if that usual practice is "clearly inadequate to protect the trust property".

In *Bentley*, a trust company was trustee of an individual's Registered Retirement Savings Plan (RRSP) and, over a period of time, the spouse of the individual forged his name on instructions to redeem shares held in the plan. Over a period of two years she managed to appropriate the entire fund to her own use. The trust company claimed that it should have been relieved from liability because it had followed "standard industry practices". The Court was not sympathetic to this claim, finding that such practices were "lax" given the facts of the case which included unskilled forgery and a suspicious pattern of withdrawals.

As a result of *Bentley*, proper supervision and the establishment of adequate procedures for protecting trust property will be crucial for a trustee seeking exoneration from liability. The importance of establishing, documenting and maintaining proper procedures cannot be emphasized enough. A court hearing evidence in a case comparable to *Bentley* is unlikely to be impressed by the "general competence" of an individual, for example, even if it can be established. Proper procedures which should be checked and reviewed will be essential.

2. Statutory

The British Columbia *Trustee Act*[21] specifically permits delegation by trustees in certain circumstances. The relevant provision is s.7 which provides:

> 7(1) A trustee may appoint a solicitor to be his agent to receive and give a discharge for money, or valuable consideration or property receivable by the trustee under the trust, and a trustee shall not be chargeable with breach of trust by reason only of his having made or concurred in making that appointment.
>
> (2) A trustee may appoint a banker or solicitor to be his agent to receive and give a discharge for money payable to the trustee under or by virtue of a policy of assurance, by permitting the banker or solicitor to have the custody of and to produce the policy

of assurance with a receipt signed by the trustee, and a trustee is not chargeable with a breach of trust by reason only of his having made or concurred in making that appointment.

(3) This section shall not exempt a trustee from any liability he would have incurred if the *Act* had not been passed, in case he permits the money, valuable consideration or property to remain in the hands or under the control of the banker or solicitor for a period longer than is reasonably necessary to enable the banker or solicitor to pay or transfer it to the trustee.

(4) This section applies only where the money or valuable consideration or property is received after July 1, 1905.

(5) This section does not authorize a trustee to do anything he is in express terms forbidden to do, or to omit anything he is in express terms directed to do, by the instrument creating the trust.

It should be noted here that the statutory protection is very limited in these provisions. It would be an unusual situation where common-law liability would attach but where the statutory provisions would shield a director from liability.

C. *Not to Profit from Office (Conflicts)*

1. Common Law

There is a long-standing rule from the common law that a trustee must act exclusively for the benefit of the purposes or beneficiaries of the trust and put his or her own interests completely aside. This rule is very strictly applied to the trustees of charities. It prohibits all profits for the trustee even if it was impossible for the trust to also profit and, indeed, even if the trust also did actually profit from a particular transaction or transactions.

The rule is expressed in the British case *Broadman* v. *Phipps*,[22] where it was stated:

> ...the fundamental rule of equity [is] that a person in a fiduciary capacity must not make a profit out of his trust which is part of the wider rule that a trustee may not place himself in a position where his duty and interests may conflict.

For the purposes of a charity, this rule would include prohibitions on such trustee actions as:

a) purchasing trust assets from the trust;

b) selling the trustee's assets to the trust;

c) accepting fees or other payments for services provided to the charity;

d) using information gained in the course of the trustee's office for profit-making purposes; and

e) using trust property in the trustee's trade or business.

2. Statutory

Section 25(1)(a) of the *Society Act*,[23] requires that directors "act honestly and in good faith and in the best interests of the society". These provisions are not substantially different from those applicable at common law.

The only other provisions of the *Society Act* which deal with conflicts of interest are sections 27 and 28 which read as follows:

> 27. A director of a society who is, directly or indirectly, interested in a proposed contract or transaction with the society shall disclose fully and promptly the nature and extent of his interest to each other director.
>
> 28(1). A director referred to in section 27 shall account to the society for profit made as a consequence of the society entering or performing the proposed contract or transaction,
>
> (a) unless
> (i) he discloses his interest as required by section 27;
> (ii) after his disclosure the proposed contract or transaction is approved by the directors; and
> (iii) he abstains from voting on the approval of the proposed contract or transaction; or
>
> (b) unless
> (i) the contract or transaction was reasonable and fair to the society at the time it was entered into; and
> (ii) after full disclosure of the nature and extent of his interest in the contract or transaction it is approved by a special resolution.
>
> (2) Unless the bylaws otherwise provide, a director referred to in section 27 shall not be counted in the quorum at a meeting of the directors at which the proposed contract or transaction is approved.

These sections have attracted considerable criticism. The most recent attack was a fairly strong one by the Law Reform Commission of British Columbia in its *Consultation Paper on Conflicts of Interest: Directors and Societies*.[24] The Commission summarized the operation of the statutory rules for the purposes of their analysis as follows:[25]

- in addition to acting honestly and in good faith, a director must act in the best interests of the corporation.

- a director must act according to the standards of a reasonably prudent person.
- a director who is, directly or indirectly, interested in a proposed contract or transaction with the corporation must advise other directors of the conflict of interest.
- other directors are able to approve the transaction before it is entered into, notwithstanding the conflict.
- if the conflict is not disclosed until after the transaction is entered into with the corporation, then only the members (of a society) or shareholders (of a company) can ratify it, by a special resolution. The transaction must have been fair and reasonable from the corporation's perspective before it can be ratified.
- approval is no good if the director does not disclose fully.
- a director who engages in a transaction that is not approved must account to the corporation for profit made from it. A court may make other appropriate orders (such as setting aside the contract).

The commission felt that this statutory structure was not adequate:

> The consultation paper suggests that existing conflict of interest rules are not effective in protecting societies and similar non-profit bodies. The current law permits a director of a society to enter into a transaction with the society so long as the director's interest is disclosed and the transaction is approved by the other directors. Those rules permit a director to profit personally from his or her connection with the society. Many people have expressed concerns that this is an inappropriate result. The concern is heightened when the society is funded by what is, in substance, public money[26].

3. Proposed Changes to Statutory Provisions

The Law Reform Commission made a number of tentative recommendations for reform of the statutory system described above. The new model, as advocated by the Commission, would formulate a new general rule that would prohibit a director of a society from entering into a transaction with the society if the director had either a direct or indirect interest in the transaction. The Commission recommended, however, that certain exceptions be made to this general rule based upon the concept that a society may enter into such a transaction if it is in the best interests of the society.

Acceptable transactions which would not need to be authorized by the board of directors of a society would include the following:

1. accepting remuneration for the director's services as a director;
2. a loan to the society guaranteed by the director;

3. a transaction between two societies in which the conflict of interest arises solely because the societies have a director in common;
4. the posting of security by a director to ensure the faithful fulfilment of the director's duties;
5. insurance for the director against personal liability incurred by virtue of the directorship;
6. an agreement by the society to reimburse a director for expenses and liabilities incurred by virtue of the directorship; or
7. participation in the activities that the society regularly makes available to its members.

The Commission also recommended that certain transactions could be authorized by a board of directors provided that: 1) the director with a conflict first disclosed the conflict, 2) it is established that the transaction was "fair and reasonable" to the society, and 3) it is established that the transaction meets "community expectations about the conduct of the society's activities". These types of transactions include the following:

1. transactions where the conflict of interest is slight or, where it is more serious, the financial consequences of the transaction are minimal;
2. a transaction which is a gift (either unconditionally or substantially in aggregate) or which represents such a substantial benefit to the society that no other decision makes economic sense;
3. a transaction which either no one else is capable of carrying out or which no one else is willing to do; and
4. a transaction which is so important to the society that it is more important for the director to participate than to avoid the conflict of interest.

In all of the above examples, the director with the conflict would be prohibited both from voting and from forming part of the quorum for dealing with the issue. The directors would also have to record in the minutes of the meeting the exception category listed above that they were relying upon in order to authorize the transaction. The directors would, in addition, be under an obligation to consider whether any special steps were necessary in the circumstances in order to confine the conflict, protect the society, or safeguard the public trust in the society's affairs.

It should be noted that all the above examples are simply the recommendations of the Law Reform Commission. None of them has any legal effect at this time.

D. Remuneration

1. Common Law

At common law, a trustee was not entitled to any remuneration for work done in the capacity of trustee. The only remuneration permitted was reimbursement of out-of-pocket expenses incurred as a result of duties required. This situation was, understandably, thought to be unfair given the often onerous nature of a trustee's duties. Consequently, the common-law position has been changed by statute in all of Canada's common-law provinces.[27]

2. Statutory

The *Trustee Act* of British Columbia permits trustees to be awarded "fair and reasonable" compensation for their work subject to certain limits. Revenue Canada, however, will not permit registration as a charitable organization unless the trust document (or incorporating documents) prohibits payment for the trustee's or director's services. If registration as a registered charity is required, the trustees or directors will not be permitted any remuneration for their services in such capacities.

Out-of-pocket expenses may be reimbursed and payment may be made for other services provided outside the capacity of trustee or director *if the trust or incorporating documents permit this.*[28] This would mean that an individual who occupied a double position as both a director and administrator could be paid a salary for his or her administrative work but could only be reimbursed for expenses associated with trustee work. Payment of a salary for trustee work is grounds for deregistration of the charity by Revenue Canada.

E. Additional Statutory Duties and Liabilities

1. *Society Act*

The *Act* requires a society to have not less than three directors (s.24(4)). Section 24(8) provides that where a society has less than three directors for more than six months "each director is personally liable for payment of every debt of the society incurred after the expiration of the six months and for so long as the number of members continues to be less than three". These provisions have the potential to create serious problems for directors who are unaware of them. They pose a particular danger to societies incorporated with only the minimum number of directors.

2. *Trustee Act*

Charitable organizations that are established as trusts lack a supervisory statute designed to oversee charitable purposes. While all the common-law provinces and the federal government have passed legislation that specifically deals with nonprofit corporations there is no similar legislation that applies to trusts set up for similar purposes. The applicable trustee legislation of the jurisdiction will apply to the trust and the trustees of the charity will be governed by its

provisions. This legislation, however, is not designed to deal particularly with charities and lacks specific provisions aimed at these institutions.

For the most part charitable trusts will be governed by the previously outlined common-law principles applicable to charities. Nevertheless, enforcement of the charitable purposes and the general law applicable to charitable trusts may be undertaken by any trust beneficiary or the Crown under its inherent jurisdiction as the protector of charities. These powers will be discussed further under "Consequences of a Breach".

3. Income Tax Act

a) *Reporting Requirements*

Section 230(2) requires that every registered charity keep appropriate records in order that Revenue Canada may verify information such as donation receipts. Trustees or directors are liable for the penalties imposed for violations of this section.

Section 227 of the *Act* imposes liability on directors who fail to remit deductions or withholding tax as required by the *Act.*

b) *Disbursement Quotas*

Disbursement quotas are probably the single most important regulatory tool that Revenue Canada uses to control the operation of registered charities. These quotas are particularly important when it comes to public and private foundations.

Disbursement quotas are designed to ensure that charities actually spend the bulk of their annual incomes on qualifying charitable causes in each year. Although both a public and a private foundation may spend money on charitable activities administered by themselves, most foundations will satisfy their obligations under the disbursement quotas by paying money to other registered charitable organizations and qualified donees who will undertake the charitable activities.

Because the objectives of disbursement quotas are to make sure that charities keep administrative costs to a minimum and to ensure that certain funds actually get spent on charitable activities, the failure to reach a disbursement quota may result in the revocation of registered charity status.

The disbursement quota for a foundation is defined as the sum of the following amounts:

1. Eighty percent (80%) of receipted donations received in the preceding year but *excluding* gifts by will and gifts made during the donor's lifetime subject to a direction that the property given (or property

substituted for it) is to be held for a period of not less than 10 years; and

2. One hundred per cent (100%) (for a private foundation) or eighty per cent (80%) (for a public foundation) of all amounts received in the preceding year from other registered charities but *excluding* "specified gifts" as defined in the *Income Tax Act Regulations.*

While disbursement quota rules are fairly straightforward, some controversy has been generated over the years with respect to a number of issues related to the guidelines.

c) *Qualified Donees*
The definition of "qualified donees" is important because it is only disbursements to "qualified donees" that can be counted in the calculation of whether a charity has met its disbursement quota. Section 149.1(1)(h) of the *Income Tax Act* defines the term "qualified donee" as follows:

> (h) "qualified donee" means a donee described in any of paragraphs 110.1(1)(a) and (b) and the definitions "total charitable gifts" and "total Crown gifts" in subsection 118.1(1)

By reference to the sections mentioned, "qualified donee" means any of the following organizations:

1. *registered* charities;
2. *registered* Canadian amateur athletic associations;
3. nonprofit housing corporations for the benefit of the aged, which are exempt from tax under paragraph 149(1)(1);
4. Canadian municipalities;
5. the United Nations and its agencies;
6. *prescribed* foreign universities (for a list see Schedule VIII to the *Income Tax Act Regulations*);
7. foreign charitable organizations to which the Government of Canada has made a gift during the taxpayer's taxation year or the 12 months immediately preceding that taxation year; and
8. the Government of Canada or of a province.

It should be noted that aside from the specific requirements of the disbursement quota system, there is a general requirement in the *Income Tax Act* that a charity must "operate exclusively for charitable purposes". Since, at common law, the transfer of funds from one charity to another is not considered to be a charitable

purpose, there is an obvious problem with the fact that the disbursement quota system permits exactly such transfers. The *Income Tax Act* solves the problem by providing, in section 149.1(1)(c), a statutory override of the common-law positions. This section provides that the disbursement of funds to a "qualified donee" (and only a qualified donee!) is a charitable purpose.

d) *Foreign Charities*

i. Payments Outside the Disbursement Quota

It will be noted that the definition of "qualified donee" is restricted quite severely in section 149.1(1)(h) as it relates to foreign charities. It is believed that a charity can gift funds which fall *outside* its disbursement quota to a foreign charity which is not a qualified donee.[29] The rationale for this belief is usually that such a payment can be made, because it falls outside the disbursement quota, only if the payment is made to an organization which devotes its resources to what would be accepted as charitable purposes in Canada. This qualification is necessary due to the fact that, as mentioned earlier, both the *Income Tax Act* and common law require charities to devote their resources to charitable objects.

The question arises, however, whether such a payment is theoretically permissible because, as also mentioned earlier, the transfer of funds from one charity to another charity is not, at common law, a transfer for a charitable purpose. Such a payment is only for a charitable purpose in Canada if the payment falls within 149.1(1)(c) of the *Income Tax Act* which is the statutory provision that deems the payment to be for a charitable purpose. Because this provision only applies to qualified donees it obviously would not apply to a foreign charity which was not a qualified donee. The payment would, therefore, not qualify technically as being for a charitable purpose.

Consequently, it would seem, at first glance, that these payments are not permissible. This problem is a technical one, however, stemming from the outdated prohibition on charity-to-charity transfers. While Revenue Canada may not detect and/or challenge such a payment, charities should be aware that the possibility exists.

ii. Agency Arrangements

There are alternative ways to fund charitable activities in a foreign country. A charity may dispatch its own employees to that country to carry on the activities or it may enter into an agency agreement whereby a foreign charity or organization becomes the agent of the Canadian charity for the purpose of carrying out the activities. A proper agency agreement would be crucial in such a situation—it would also be wise to get the agreement approved in advance by Revenue Canada.[30] A charity contemplating an arrangement like this should also make sure that its bylaws permit such activity.

e) Grounds for Revocation of Charitable Status
While the list of grounds for revocation is fairly specific, it is generally understood that revocation is not automatic following a breach. There will normally be a period of consultation between Revenue Canada and the charity in order to determine whether the breach can be rectified so as to enable the charity to continue with its status unaffected. The list of grounds for revocation is contained in Revenue Canada's *Information Circular* 80-10R, "Registered Charities: Operating a Registered Charity", December 17, 1985.

For all charities, section 168(1) of the *Income Tax Act* indicates that revocation of charitable status may occur where:

1. The charity applies in writing for such revocation;
2. The charity ceases to comply with the requirements of the *Act* for its registration as such;
3. The charity fails to file a return of information;
4. The charity issues a receipt for a gift or donation otherwise than in accordance with the *Act* and Regulations or that contains false information;
5. The charity fails to keep proper records;
6. The charity fails to provide information or books and records as required under subsection 230(2).

The major factor which might cause revocation of charitable status is number 2. The *Information Circular* lists examples of non-compliance which Revenue Canada would view as being grounds for revocation for all types of charities:

1. The charity allows any part of its income to be made available for the personal benefit of any proprietor, member, shareholder or trustee (this does not include the payment of reasonable salaries or normal employee benefits or the reimbursement of out-of-pocket expenses);
2. The charity gives away any of its income to organizations to which a Canadian taxpayer may not make a deductible gift, (e.g., to a charity that is not a registered charity);
3. The charity gives funds for personal use to individuals who have been selected by the donor;
4. The charity makes a gift to another "registered charity" with the purpose of unduly delaying the expenditure of amounts on charitable activities;

5. The charity is the recipient of a gift from a registered charity and is aware that the main reason for making the gift is to delay the donor's expenditure of amounts on charitable activities.

In addition, for public foundations the following grounds are also applicable:

1. It ceases to operate exclusively for charitable purposes;
2. It carries on an unrelated business (Note: it can only carry on a business that is unrelated to its objects if substantially all of the people employed to operate it are not remunerated);
3. It has acquired control of any corporation since June 1, 1950 ("control" is defined in paragraph 149.1(12)(a));
4. Since June 1, 1950, it has acquired debts other than those related to current operating expenses, purchase of investments, or administration of charitable activities;
5. It fails to meet its "disbursement quota" as defined by paragraph 149.1(1)(e) of the *Act*.

f) Payments to Registered and Non-Registered Charitable Organizations

The problems applicable to payments from a registered charity to a foreign charity also apply to payments from a registered charity to a nonregistered Canadian charity (e.g., an organization set up for charitable purposes which is not formally registered with Revenue Canada). Once again, a payment to a charity which is not registered is not a payment to a qualified donee. Consequently, technically, the payment will not qualify as an expenditure for charitable purposes because it will not fall within s.149.1(1)(c) which overrides the common-law position that such payments are not an activity qualifying as a charitable purpose. As a result, while such payments would have to fall outside the disbursement quota qualifications and thus would probably not be detected by Revenue Canada without an audit, the payments fall within the "grey zone" created by this conundrum. Conservative charities will probably want to avoid such transfers.

As noted earlier, there are methods which can be employed in order to fund a program or activity which is charitable but which, by virtue of scope or resources, does not have its own charitable registration number.

g) Political Activities

Over the years political activity has caused the most problems. It is well established that political activity on its own does not qualify as charitable activity.

Political activity may be undertaken, however, incidental to charitable activity in order to achieve a goal which is charitable. Many charities undertake political lobbying on behalf of the causes that they further as charitable activity (e.g., an anti-poverty group lobbying for changes to welfare payments).

The extent to which a charity may engage in political activities has been, and continues to be, the subject of controversy. In 1985, the federal government made changes to the *Income Tax Act* to permit charities to carry on a limited range of political activities. Section 149.1(6.1) is applicable in this regard for public foundations and reads as follows:

> (6.1) For the purposes of paragraph (1)(a), where a corporation or trust devotes substantially all of its resources to charitable purposes and
> (a) it devotes part of its resources to political activities,
> (b) such political activities are ancillary and incidental to its chartable purposes, and
> (c) such political activities do not include the direct or indirect support of, or opposition to, any political party or candidate for public office.
>
> The corporation or trust shall be considered to be constituted and operated for charitable purposes to the extent of that part of its resources so devoted.

It should be noted that Revenue Canada considers that "substantially all" of a charity's resources as indicated in the section means 90 per cent or more. In addition, section 149.1(1.1) indicates that expenditures on political activities are not considered to be expenditures for charitable activities. Thus, while a limited amount of such expenditures is permissible without violating the overall requirement that the organization devote its resources to charitable activities, these expenditures are specifically excluded from the charity's disbursement quota. Further information on these restrictions is provided in *Information Circular* No. 87-1 which indicates, among other things, that certain "political" activities such as representations to elected representatives will be considered to be charitable at law rather than political and thus could be included in the calculation of a disbursement quota.

III. How a Breach Occurs

Any violation of the responsibilities and obligations listed above will usually create a breach of trust or of fiduciary duty, or both. In summary, a breach of trust will result if there is:

1. Failure to carry out the specific duties and obligations outlined in the terms of the trust or incorporating documents;

2. Failure to respect the general rules listed above which form the basic essence of fiduciary conduct; or

3. Failure to observe any of the various statutory rules and requirements that are applicable. This may create liability under the statute itself and such conduct will also usually constitute a breach of trust.

Breach of trust or of fiduciary duty can arise out of positive action (doing something that is prohibited) or negative action (failing to do something that is required). Note in particular that a failure to *consider* whether to exercise a power is a breach of trust.

IV. Consequences of a Breach

A. *Common Law—Directors*

1. Action Within Director's Authority
   If a director acts within the scope of his or her authority, then liability will attach only if real losses are suffered by the society as a result of actions which breach one of the legal standards of conduct previously discussed.
2. Action Outside Directors' Authority (*Ultra Vires*)
   The doctrine of *ultra vires* holds that an incorporated body cannot undertake any activities which are outside the constraints of the activities that it is empowered to undertake as outlined in the body's incorporating documents. The doctrine flows from the principle that since an incorporated body is a legal fiction (or simply a creation of a statute), it is empowered to do only that which the statute that created it empowers it to do. Historically, incorporating statutes empowered a corporation to do only what was stated in its articles and bylaws as its objects or purposes. This doctrine has been abolished for corporations incorporated under the British Columbia *Company Act.* All such corporations are given the full powers and capacity of a natural person.

There is considerable uncertainty, however, about the application of the *ultra vires* doctrine to societies incorporated under the British Columbia *Society Act.* Section 4(1)(d), for example, provides that:

> From the date of the certificate of incorporation the members of the society are members of a corporation
>
> (d) with the powers and capacity of a natural person of full capacity *as may be required to pursue its purposes.* (emphasis added)

In addition, section 32(1) provides that:

> (1) The funds and property of the Society shall be used and dealt with *only for its purposes in accordance with its bylaws.* (emphasis added)

The combined effect of these two sections seems to be that the *ultra vires* doctrine still remains in force for societies incorporated under the *Society Act.*

The unfortunate result of this confusion is that individuals who undertake what they believe is society business may find themselves to be personally liable for any subsequent claims made against the society if the business undertaken actually extends beyond the society's permitted purposes. One does not have to look very far to come up with frightening examples: A director signs a contract which is *ultra vires* the society and thereupon becomes personally liable for breaches of it; an accident at a business operated by the society creates personal liability of the directors for the victim's consequent damages award if the business is found to be *ultra vires* of the society's constitution. The possibilities are worrying.[31]

B. Statutory—Directors

Contravention of the provisions of the *Society Act* can result in an investigation by the Registrar who may then order compliance with the *Act* if necessary.[32] Obstruction of the investigation or failure to comply with an order constitutes an offence under the B.C. *Offence Act*. The courts also have the power to order compliance with the *Act*.[33]

C. Trustees

A breach of trust under the common law or a breach of a trustee's responsibilities under the *Trustee Act* give rise to the possibility of an action by a beneficiary under the trust or by the Crown under its inherent jurisdiction as protector of charitable interests. In such an action claim could be made for any one or more of the following remedies: 1) an order preventing the action complained of or requiring a particular action, 2) an accounting of the financial dealings of the trust during the period in question, 3) removal and replacement of a trustee or trustees, or 4) a claim against a trustee or trustees personally for any losses the trust has incurred as a result of the breach.

In some jurisdictions, such as Ontario, legislation has been passed which defines in some detail the responsibilities and duties of trustees of a charitable trust. In British Columbia, however, there is no such legislation and the enforcement power rests solely in the common law. While it is possible that a beneficiary could make such a claim, the Crown also has the right to do so. Donovan Waters discusses the Crown's rights in this regard in the following passage. (Note that the Crown's duty to bring such an action is entirely discretionary.)

> Under its prerogative power, [the Crown] was a protector of charities and therefore concerned with the maladministration of charitable trusts. Primarily, the Crown was thus concerned to see that funds were properly handled and that expenditures were only made upon trust objects. It would also sue to recover charitable funds which had been fraudulently made available to third parties. This responsibility of the Crown devolved upon the senior law officer, the Attorney General, as one of his many tasks,

> and for three centuries at least the Attorney has discharged it, first in England and then later in all other common law jurisdictions where his counterpart, or a nominee like the Public Trustee, has assumed the role....It is probable that, without any previous complaint or critical information being brought to the Attorney's attention, the prerogative to investigate charities, if it exists, would not be exercised. And, even when the Attorney does receive such a complaint or information, it is entirely within his discretion whether he takes any legal or other action. That is the nature of the prerogative, power rather than duty, *parens* and not *mandatarius* of the charity.[34]

V. Co-Fiduciary Liability

The question that arises in this section is to what extent a fiduciary who is a member of a group of fiduciaries (e.g., a board of trustees or directors) is liable for the personal acts and omissions of his fellow fiduciaries which result in a breach of fiduciary duty. The standards are different for trustees and directors.

A. *Trustees*

The fundamental principle is that a trustee or fiduciary is liable only for his or her own acts and omissions and not those of co-fiduciaries. However, a fiduciary may not remain idle and passive in the execution of required duties. "Rubber stamping" of decisions made by co-fiduciaries is not permissible. This principle was recently confirmed in *Wagner* v. *Van Cleef.*[35]

In *Wagner*, one of the two administrators provided the other, a lawyer, with a general power of attorney and left all matters of the estate in the lawyer's hands. The lawyer subsequently absconded with a great deal of his clients' money, including the assets of the estate. At the trial level the judge excused the absent administrator from liability on the ground that he had acted honestly and reasonably. On appeal, however, the appellate court disagreed, stating that, although the absent administrator had acted honestly, he had not acted reasonably. The Court held that a trustee must meet a minimum standard of trustee conduct:

> Ignorance of an administrator's duties does not make a defaulting trustee's action reasonable, nor does complete reliance on others, including solicitors....In my view it is unreasonable by any standard for an administrator to fail to assume any direct responsibility for the administration of an estate....Two factors that can prevent relief under s.35 of the *Trustee Act* are overreliance on others and carelessness.[36]

To avoid liability for the acts of a defaulting co-fiduciary a fiduciary must show that he or she was not personally at fault in the breach. Thus, where a fiduciary leaves the management of trust property to a colleague, there is negligence and consequent liability for any breaches of trust committed by that colleague. There are three recognized instances where a fiduciary would be liable because of negligent conduct:

1. Where the fiduciary receives money and hands it over to another fiduciary without further concern as to its due application;
2. Where the fiduciary allows a co-fiduciary to receive money and makes no enquiry as to its application; and
3. Where the fiduciary becomes aware of a breach of trust either committed or meditated by a co-fiduciary and wilfully abstains from noticing it and from taking steps to obtain restitution or redress.

These general rules are modified when applied to particular types of fiduciaries:

1. When a lay person is a co-fiduciary with a solicitor, the lay person may be excused from liability because of a special relationship which exists between the two fiduciaries;[37]
2. A retiring fiduciary will normally not be held liable for breaches of trust subsequently committed by a successor. However, if the breach was predictable as a result of the former fiduciary's retirement and replacement by the successor fiduciary, then liability could result; and
3. If a successor fiduciary discovers a breach of trust committed prior to taking office and takes no steps to obtain redress, liability will ensue.

As a result of the foregoing, by accepting an appointment as a fiduciary each individual of a group of fiduciaries is under a duty to participate actively in the administration of the charity. This responsibility carries with it the duty to use reasonable care to ensure that a co-fiduciary does not commit a breach of trust and if he or she does, then the fiduciary, if he or she knows of the breach or ought reasonably to have known of the breach, also has an obligation to see that the breach is corrected.

The obligation to correct a breach when a trustee becomes aware of it is a difficult one to quantify. The extent of an individual's obligation may, depending upon the circumstances and the seriousness of the breach, give rise to a duty to apply to the court to prevent or correct the breach or, in extraordinary circumstances, may require notification of the breach to the beneficiaries or potential beneficiaries. Since the trustee can only be indemnified for court costs, it may put the trustee in a difficult financial position. An inquiry or complaint to the Crown may be a more acceptable solution for a concerned trustee faced with this kind of situation. The Crown might then proceed, under its inherent jurisdiction, to investigate the matter.

B. Directors

At common law, and in the absence of specific provisions in a company's incorporating documents, liability for the actions of a corporate board of directors usually only attaches to those directors who vote for a particular resolution. However, the British Columbia *Company Act* s.151(6) does include deeming provisions so that directors who are absent from meetings may be deemed to consent to a resolution unless they register a specific dissent. The British Columbia *Society Act* does not contain the same provisions as the *Company Act* and thus it would seem that the common-law position—that there is no co-fiduciary lability—will prevail.

VI. Relief from Liability

A. Exculpatory Clauses

A trust document may contain an exculpatory clause which purports to minimize or reduce the liability to which fiduciaries might otherwise find themselves subject. Generally speaking, the courts have been strongly biased against such clauses, seemingly motivated by a desire to ensure that the stringent obligations associated with fiduciary conduct are preserved.

Often, on the surface, it seems that exculpatory clauses have a far-reaching effect and would shield trustees from liability arising out of most claims against them. However, as mentioned above, the courts have generally placed a very narrow and strict interpretation on such clauses in the areas of both trust and contract law. A recent ruling of the British Columbia Court of Appeal[38] listed five types of actions which will always be subject to judicial review regardless of the existence of an exculpatory clause:

1. The trustees failed to exercise their discretion at all;
2. The trustees acted dishonestly;
3. The trustees failed to exercise the level of prudence to be expected of a reasonable businessperson;
4. The trustees failed to hold the balance evenly between beneficiaries; and
5. The trustees acted in a manner prejudicial to the interests of the beneficiary.

Consequently, it is believed that most exculpatory clauses do not provide significant levels of protection to trustees. It is highly unlikely that an exculpatory clause would protect against a violation of either basic fiduciary obligations or of the "reasonableness" standard.

B. Liability Insurance

Liability insurance may be considered in order to protect directors or trustees. The use of charitable funds to insure a director or trustee against personal liability, however, is probably not a use for a charitable purpose and would probably not be permitted at common law. As a result, in the case of a trust, the trust instrument will probably specifically have to permit this use of funds. In the case of a society, s.30(5) of the *Society Act* permits a society to insure a director against personal liability incurred in the execution of the office.

Personal liability insurance is becoming prohibitively expensive. In addition, exclusions in the policies are becoming more and more common. If *ultra vires* actions are a concern, the policy should specifically include such actions as an insured risk.

C. Society Act

Section 30(2) of the *Society Act* provides that:

> A society may, with the approval of the court, indemnify a director or former director of the society or a director or former director of a subsidiary of the society, and his heirs and personal representatives, against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, actually and reasonably incurred by him, in a civil, criminal or administrative action or proceeding to which he is made a party by reason of being or having been a director, including an action brought by the society or subsidiary, if
>
> (a) he acted honestly and in good faith with a view to the best interests of the society or subsidiary of which he is or was a director; and
>
> (b) in the case of a criminal or administrative action or proceeding he had reasonable grounds for believing his conduct was lawful.

It should be noted that this section covers only directors, not officers. Also, court approval is needed for any indemnification. It could be argued that this section also extends to *ultra vires* actions of directors.[39]

D. Trustee Act

Because the standard of fiduciary conduct is so strict, section 98 of the *Trustee Act* confers upon the courts a discretionary power to relieve a trustee from liability when the breach of trust has been "technical" or when the breach arises when the trustees have nonetheless acted "honestly and reasonably". It should be noted, however, that this type of relief from a breach of trust is always at the (often unpredictable) discretion of the court. Section 98 provides as follows:

> If it appears to the court that a trustee, however appointed, is or may be personally liable for a breach of trust, whenever the transaction alleged to be a breach of trust occurred, but has acted honestly and reasonably, and ought fairly to be excused for the breach of trust and for omitting to obtain the directions of the court in the matter in which he committed the breach, then the court may relieve the trustee either wholly or partly from the personal liability.

VII. Conclusion

In the final analysis the common-law standard of fiduciary conduct which governs directors will be the same high standard that governs trustees. Though finding the correct course of action may not be easy, the contemporary director of a society or charitable organization should assume that he or she will be bound by the principles of trust law as it applies to fiduciary behaviour as well as by the principles of corporate law. In these circumstances the safest course of action for the director, though regrettably it may not be the most satisfactory way to apply the law, is to determine which body of law applies in the particular situation and then apply the most stringent standard in that law.

FOOTNOTES

1. See, for example, two articles in a recent C.L.E. publication: Morley J. Greene, "Duties and Liabilities of Directors and Trustees" and E. Blake Bromley and Gordon B. MacRae, "The Duties and Liabilities of Directors of British Columbia Societies" in *Charities and Non-profit Organizations 1992* (Vancouver: C.L.E. of B.C., 1992).
2. (1987), 60 O.R. (2d) 236. [For a case comment see (1990), 9 *Philanthrop.* No. 1, pp. 36-42.]
3. R.S.O. 1990, c.10.
4. (1990), 69 O.R. (2d) 742. [For a case comment see (1990), 9 *Philanthrop.* No. 1, pp. 36-42.]
5. *Ibid.*, at 747.
6. See Donald J. Bourgeois, *The Law of Charitable and Non-profit Organizations* (Toronto: Butterworths, 1990) at 66.
7. However, statutory law, such as s.151(6) of the *Company Act* of B.C., may create deemed consent to missed resolutions.
8. [1977] 2 S.C.R. 302.
9. [1985] 1 Ch. 270.
10. *Ibid.*, at 289.
11. (1887), 12 A.C. 727 at 733 (H.L.).
12. (1886), 33 Ch. D. 347 at 355 (C.A.).
13. D.W.M. Waters, *The Law of Trusts in Canada* (Toronto: Carswell, 2nd ed. 1984) at 781-783.

14. See the discussion in Waters, *ibid.*
15. R.S.B.C. 1979, c.390.
16. This issue is discussed in more detail below and by Bromley and MacRae, *supra*, footnote 1, at 2.1.31.
17. See *Shaw, Woosley & Stoney* v. *Real Estate Board of Greater Vancouver*, [1974] 5 W.W.R. 193 (B.C.S.C.).
18. See *McLellan Properties Ltd.* v. *Roberge*, [1947] S.C.R. 561 at 566.
19. See *Speight* v. *Gaunt* (1893), 9 A.C. 1.
20. (1992), 48 E.T.R. 111 (B.C.S.C.).
21. R.S.B.C. 1979, c.414.
22. [1967], 2 A.C. 46 at 123.
23. *Supra*, footnote 15.
24. (Vancouver: Law Reform Commission of B.C., 1993).
25. *Ibid.*, at 14-15.
26. *Conflicts of Interest: Directors and Societies – Summary of the Consultation Paper* (Vancouver: Law Reform Commission of B.C., 1993) at 1.
27. In British Columbia, the *Trustee Act*, *supra*, footnote 21.
28. See *Harold G. Fox Education Fund* v. *Public Trustee*, *supra*, footnote 4 and *Allen* v. *Allen Estate* (1991), 57 B.C.L.R. (2d) 351.
29. See M.L. Dickson, "Fights Involving Foreign Entities" (1986), 6 *Philanthrop.* No.1.
30. For more information on this topic, see Drache, *Canadian Taxation of Charities and Donations* (Toronto: Richard DeBoo, updated annually).
31. For more examples and discussion of this issue, see Bromley and MacRae, *supra*, footnote 1, at 2.1.21.
32. *Supra*, footnote 15, section 85.
33. *Ibid.*, section 86.
34. *Supra*, footnote 13, at 633.
35. *Wagner* v. *Van Cleef* (1991), 5 O.R. (3d) 477 (Div.Ct.).
36. *Ibid.*, at 489.
37. But see *Wagner* v. *Van Cleef*, *supra*, footnote 35.
38. *Boe* v. *Alexander* (1987), 15 B.C.L.R. (2d) 106 (C.A.).
39. See Bromley and MacRae, *supra*, footnote 1, at 2.1.41.