Duties and Responsibilities of Directors

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Most people accept a position as director on the board of a charity on the basis of their commitment to the charitable endeavour, usually with scant regard for the legal responsibilities of such a position. Yet, while directors may focus their attention on the altruistic promotion of charitable activities, they also have definite legal responsibilities to members, employees, shareholders, creditors and governments. They must be honest, careful, diligent and prudent.

The duties and responsibilities of directors in Canada are diverse and far ranging. Increasingly, duties which were imposed by the courts at common law are being enshrined into statutory responsibilities. In addition to the responsibilities in the legislation under which the charity was incorporated, there are rules in the *Income Tax Act* governing the operation of charities with which the directors must comply. Directors involved in fraud may be caught by provisions in the *Criminal Code of Canada* such as section 355 which makes it an offence to destroy or falsify documents so as to defraud creditors or section 350 which makes it an offence to fail to keep accounts so as to defraud creditors.

While directors may admire the willingness of the charity's employees to forego salaries when income is inadequate, they should be aware that nevertheless directors may have personal liability for such unpaid wages.

For example, directors of charities and other non-profit corporations incorporated under the *Corporations Act* of Ontario have a liability for up to six months' wages for employees by virtue of the combined effect of sections 82 and 134(1). British Columbia had a similar requirement but in 1980 a new *Employment Standards Act* was passed and section 19 reduced the director's personal liability to two months' unpaid wages. Regulations pursuant to that *Act* which became effective in 1982 state that:

> "12.1 Section 19 of the Act does not apply to a director or officer of a charity where the director or officer does not receive any remuneration other than reasonable out-of-pocket expenses for services performed by him for the charity."

One of the problems in determining what are the duties of the director of a charity is the inadequacy of the legislation governing the incorporation and management of charities. Historically, governments tried to design legislation governing charities in ways which were consistent with the rules governing the operation of business corporations. However when the laws governing corporations became obsolete and were updated the legislation governing charitable organizations was left untouched.

In 1975 the federal parliament passed the *Canada Business Corporations Act* to update the legislation governing federally incorporated corporations but left in place Part II of the old *Canada Corporations Act* under which charities must still

be incorporated. Bill C-10, being an *Act Respecting Non-Profit Corporations*, is still languishing in committee in the House of Commons and it is not clear when this will be passed into law. Ontario updated its corporate law with the *Ontario Business Corporations Act* but charitable and other non-profit corporations continue to be incorporated under the old *Ontario Corporations Act.*

British Columbia rewrote its *Company Act* in 1973 but did not complete the rewriting of its *Society Act* which governs charities until 1977. Both because I practise law in the province of British Columbia and because the British Columbia *Society Act* is the most recently enacted legislation governing charities, this article will concentrate on that legislation in its discussion of the statutory duties and responsibilities of directors.

Most of the case law on directors' duties deals with directors in the corporate, rather than the charitable world. It is, therefore, necessary to examine the responsibility of corporate directors as a basis for understanding the duties of directors of charities. It is also important to look at directors' duties under the common law as well as those imposed by statute. The standards set by the common law would govern charities incorporated in Ontario under the *Corporations Act* as that act does not have a statutory standard of care similar to the objective standard set out in the *Ontario Business Corporations Act.* The British Columbia *Society Act* has a statutory standard of care but clearly states that it is in addition to the common-law duties.

The common law applied a subjective test in *Re City Equitable Fire Insurance Co.*[1] in which Romer L.J. laid down the test of skill for a director as: what may reasonably be expected from a person of his knowledge and experience. In discussing directors' duties the Chief Justice of the Supreme Court of Canada in *Canadian Aero Service* v. *O'Malley*[2] stated that the director's duty is one of loyalty, good faith, avoidance of conflict between duty and interest and avoidance of personal profit. The *Canadian Aero Service* case extended the standard of care required by a director. The courts are beginning to suggest that the "whole ability" of directors must be given and that directors may be liable to shareholders for "business judgement".

It is somewhat ironic that in the corporate world the director's opportunity for gain is limited by his salary but his liability is unlimited, whereas shareholders have unlimited opportunity for gain but no liability whatsoever. In the charitable world, the director has the responsibility to ensure not only that all of the resources and income are utilized exclusively for charitable purposes and activities but also that no part of the income is used for the personal benefit of any of the directors, members or settlors.

The principal duty of directors is to be honest, which includes the demonstration of good faith and loyalty, in the exercise of their powers and discretion. Honesty requires that when dealing with a charity's interests, directors must tell the whole truth and nothing but the truth. Typically, the cases arising involve misuse of funds, misappropriation of corporate property, improper loans, improper dividends, and appropriation of corporate opportunity. It is important to note that breach of the duty of honesty requires active error or misfeasance and not merely passive inactivity or nonfeasance.

The duty of good faith primarily requires the directors to act in the best interests of the company. It does not allow them to pursue an improper purpose in the exercise of their powers. Prior to *Teck Corporation Ltd.* v. *Millar, Price, Harmabourne and Afton Mines Ltd.*[3] the courts held that it was an improper purpose for the directors to take any action or confer any benefit which did not directly enhance the interests of the corporation and its shareholders. In the *Teck* case the Supreme Court of British Columbia said that it was not an "improper purpose" for the directors to confer a benefit outside of the corporation where it could be seen to have an indirect and intangible benefit to the corporation.

In the charitable world the "improper purpose" test has greater significance since a charitable organization or foundation is likely to have much more restrictive purposes than a business corporation. It is important that directors keep those purposes in mind when they are approving programs and expenditures. Charitable activities undertaken or supported must not only be analyzed in terms of their value as programs, but also in terms of whether they fall within the charity's avowed "purposes".

The *Teck* case is important authority for the type of analysis undertaken by the court in ascertaining whether the directors were indeed acting in the best interests of the company. The court suggested that something more than a mere assertion of good faith by the directors was necessary to sustain their exercise of power. The court specifically enquired into the belief of the directors at the time the events in question occurred. Further, the court considered whether the directors' allegations of *bona fides* were reasonable on the facts. The court drew an analogy to the distinction in conspiracy-to-injure cases where the test becomes: was the primary purpose to promote the interests of oneself or to damage the interests of others?

It is worth noting that the courts have been reluctant to enter the sphere of "business judgment". Lord Justice Scrutton in *Shuttleworth* v. *Cox Brothers*[4] suggests, "It does not matter whether or not a court would come to the same decision" and further that, "It is not the business of the court to manage the affairs of the Company". Thus it would appear that in the absence of evidence to the contrary, directors will be presumed to be acting in the best interests of the company. However, as noted earlier the courts are moving towards also requiring directors to use "business judgement".

The duty of honesty also includes an element of loyalty. This could be seen as avoiding the conflict of duty of interests or property between the director and the company. Historically contracts have always been voidable in equity if there was such a conflict. The test adopted in *Aberdeen Railways*[5] was that no fiduciary "can have an interest that possibly conflicts with the interests of those whom he is bound to protect". The court continued that it is no defence that the act was "fair and reasonable" and that *mala fides* is not in issue.

In the strict view applied in *Regal (Hastings) Ltd.* v. *Gulliver*[6] Viscount Sankey suggested that liability does *not* turn on *mala fides*. The test is simply whether one "has or can have a personal conflict". Lord Russell suggested that a fiduciary must "account for profits made while standing in a fiduciary capacity by reason and in course of that fiduciary relationship made a profit".

There is no general rule as to when a conflict of interest will be actionable. The cases in Canada have been inconsistent as to the need for the company to actually suffer a loss. In the *Canadian Aero* case, Chief Justice Laskin of the Supreme Court of Canada said that the court would look to all circumstances of the transaction and suggested that the following were all relevant factors: the position held, the nature of the corporate opportunity, the ripeness of the corporate opportunity, the specificness and relationship of the officers to the opportunity, and the amount of knowledge possessed.

There is uncertainty in advising directors as to their potential liability should they depart from the best interests of the company. It is to be anticipated that the absence of the ability of the corporation to take advantage of the opportunity is no defence by a fiduciary. The strict rules of equity would seem to apply. The most prudent course is to anticipate legal liability where a conflict exists even if no loss was suffered by the charity and even though the charity did not have the ability to take advantage of the opportunity.

There has been an increasing tendency to enshrine the duties of a director developed at common law into a statutory responsibility. When this is done, the statute almost invariably goes on to say that the statutory duties 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. This means that while there is a minimum standard imposed by statute it is still possible that a higher standard required by common law or equity may be invoked.

When British Columbia rewrote its *Society Act*, it was brought in line with the *Company Act*. Thus, the *Society Act* now imposes substantially the same duties on directors as does the *Company Act* and incorporates, by reference, portions of provisions of the *Company Act* relating to borrowings. Section 25 of the *Society Act* imposes a statutory standard of care on directors, stating:

> "(1) A director of a Society shall
>
> (a) act honestly and in good faith and in the best interests of the Society; and
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> (b) exercise the care, diligence and skill of a reasonably prudent person, in exercising his powers and performing his functions as a director.
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> (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."

Having imposed this statutory duty and having stated that it is in addition to, and not in derogation of, any common-law duties, the legislation goes further in saying that there are no ways a director can gain immunity from those duties. Section 26 states:

> "Nothing in a contract, the constitution or the by laws, or the circumstances of his appointment, relieves a director
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> (a) from the duty to act in accordance with this Act in 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."

The *Society Act* goes on to require in section 27 that:

"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."

This is in fact a higher standard than imposed by the comparable provisions in the British Columbia *Company Act*. The *Company Act* does not include the words "fully and promptly" and allows disclosure "at a meeting of the directors" rather than to "each other director".

The British Columbia *Society Act* and the *Company Act* have identical provisions requiring a director to account for any profit made as a consequence of the society entering or performing a contract or transaction in which the director had a direct or indirect interest. Both acts allow an exception for accounting for profits if "the contract was reasonable and fair to the Society at the time it was entered into" and was approved by a special resolution. This would seem to remove the fear that a director may be sued under the strict rule in *Regal (Hastings) Ltd.* if it were not for the statutory caution that these duties are not in derogation of any common-law duties.

While a director may not be granted immunity from his duties, a society may, with the approval of the court under section 30, indemnify a director against all cost charges and expenses incurred by him 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 the criminal or administrative action or proceeding he had reasonable grounds for believing his conduct was lawful."

The legislation further allows a society to purchase insurance for the benefit of the director against personal liability incurred by him as a director.

While the standard of care required of a director of a charity is theoretically very high, there is a suspicion that in practice the liability of the director may be determined by the "good guy/bad guy" theory of law. If a director is acting fraudulently or is grossly negligent there is plenty of case law and statutory authority to hold him responsible. However if the director is acting in good faith but does not fulfill all his res ponsibilities there is authority to absolve him from liability or indemnify him for any damages.

FOOTNOTES

1. [1925] Ch. 407.
2. (1974), 40 D.L.R (3d) 371 (S.C.C.).

3. [1973] 2 W.W.R. 385 (B.C.S.C.).
4. [1927] 2 K.B. 9.
5. [1854] 2 Eq. Rep. 1281 (H.L.).
6. [1924] 1 All E.R. 378 (H.L.).