

Directors of Quebec non-profit organizations (“NPOs”)

By *André Laurin*

OVERVIEW

- Directors of NPOs are subject to substantially the same duties and liabilities as directors of for-profit companies
- Being a director of an NPO is not merely an honorary role
- The corporate governance rules recommended for or imposed on reporting issuers are examples of best practices for NPOs; however, like for small businesses, they should be adapted, depending on the situation, to avoid unduly complicating the NPO’s processes
- Special attention should be paid to certain differences in approach based on
 - the objects or purposes of the NPO
 - the membership or required representation
 - the meaning to be given to the “interest of the legal person”
 - in certain cases, the receipt of donations and grants
- The best interest of an NPO which is a legal person is that which is in keeping with the pursuit of its objects and thus its purposes
- An NPO which is a charitable organization is subject to certain additional rules which the directors should keep in mind



1. CONTEXT

There are many NPOs in Quebec which are incorporated or have **legal personality**. They are involved in areas such as education, health, the arts, community activities, sports, charitable or philanthropic activities, and socio-political or socio-economic action.

Such NPOs need directors as much as for-profit corporations do*. Many people agree to help these NPOs by acting as directors without considering the **duties and risks** involved in accepting and performing such duties.

The boards of directors of NPOs generally do not have the support in the form of human resources and funds that the boards of for-profit companies do. Many NPOs also receive **advances, donations or grants** which are given or allocated subject to specific conditions which the NPO must meet. The income tax laws impose additional rules on NPOs which are authorized to issue tax receipts.

In this newsletter, we will recall certain basic rules and describe how, in certain respects, the role or, more specifically, the manner in which a director of an NPO approaches his role, differs from that of a director of a for-profit company.

* N.B.: a business corporation may be not-for-profit.



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2. SIMILARITY OF BASIC RULES

General obligations

In Quebec, NPOs are usually incorporated under **Part III of the Companies Act**¹. However, some are incorporated under **Part II of the Canada Corporations Act**².

Under the rules of interpretation of the CCQ³, the statute under which an NPO is constituted governs the powers, obligations and liability of an NPO which carries on its activities in Quebec. However, where the constituting act is silent in this regard, the CCQ will be the main source of law, complementing the constituting act.

Under the Civil Code of Québec ("CCQ"), a **director** is considered a **mandatary** of the company and is subject to **articles 321 to 330 CCQ** and, by reference, to **articles 2130 to 2195 CCQ** on mandate. The following are the **relevant provisions** concerning the obligations of directors:

"321. A director is considered to be the mandatary of the legal person. He shall, in the performance of his duties, conform to the obligations imposed on him by law, the constituting act or the by-laws and he shall act within the limits of the powers conferred on him.

322. A director shall act with prudence and diligence.

He shall also act with honesty and loyalty in the interest of the legal person.

323. No director may mingle the property of the legal person with his own property nor may he use for his own profit or that of a third person any property of the legal person or any information he obtains by reason of his duties, unless he is authorized to do so by the members of the legal person.

324. A director shall avoid placing himself in any situation where his personal interest would be in conflict with his obligations as a director.

A director shall declare to the legal person any interest he has in an enterprise or association that may place him in a situation of conflict of interest and of any right he may set up against it, indicating their nature and value, where applicable. The declaration of interest is recorded in the minutes of the proceedings of the board of directors or the equivalent.

...

2138. A mandatary is bound to fulfill the mandate he has accepted, and he shall act with prudence and diligence in performing it.

He shall also act honestly and faithfully in the best interests of the mandator, and avoid placing himself in a position that puts his own interest in conflict with that of his mandator."

These **provisions apply to both** directors of for-profit companies and directors of NPOs. They are, for the most part, similar to those found in subsection 122 (1) of the *Canada Business Corporations Act*⁴ ("CBCA") applicable to the directors of business corporations incorporated under that statute. Part II of the Canada

Corporations Act is silent in this regard but the common law principles regarding fiduciary duties were used as a basis to draft the provisions concerning the obligations of loyalty and honesty prescribed by the CCQ and the directors of Part II corporations therefore also have similar obligations.

The duties imposed by law require that a **director must act**

- **personally** (no substitutes);
- **within the limits of the powers** conferred on him;
- **in compliance with the law**, the **constituting act** and the **by-laws**;
- with **prudence** and **diligence**;
- with **honesty** and **loyalty**, in the **interest of the legal person**;

¹ R.S.Q., c. C-39.

² R.S.C. 1970, c. C-32.

³ Article 300 CCQ; Section 8.1 *Interpretation Act*, R.S.C. 1985, ch. I-21; *Peoples Department Stores Inc. (Trustee of) v. Wise* (2004) 3 S.C.R. 461 (the «Wise case»), at paragraphs 29 and 54; *Canada 3000 Inc., re: Inter-Canadian (1991) Inc. (Trustee of)*, 2006 SCC 24, at paragraphs 78 to 82.

⁴ R.S.C., (1985), ch. C-44.

Civil and penal liability

As shown by the recent Quebec Court of Appeal decision in *Métromédia C.M.R. Montréal inc. v. Johnson*⁵, directors are subject to **basic civil liability** (art. 1457 CCQ), just like anyone else in the company, if they fail to fulfil their duty not to cause injury to others. They must also honour their contractual undertakings (art. 1458 CCQ). In addition to this basic civil liability, directors of NPOs, like the director of for-profit companies, are also subject to certain **civil and penal liabilities**.

These **statutory liabilities** (specific liabilities explicitly set out in the law) **include**:

- debts related to tax liabilities (deductions at source, collection and remittance of the GST and QST, etc.);
- prohibited loans to members;
- non-compliance with certain corporate requirements (record-keeping, etc.); and
- failure to deposit in trust sums of money collected from a consumer when the principal obligation of the NPO is to be performed by it more than two months after the contract is made⁶.

The liability of the director toward the NPO is legal and contractual. In other words, if the mandatary's failure to fulfil his duties toward the NPO results in damage to the NPO, the NPO may hold him liable. In certain circumstances, if the NPO refuses to act, the members may do so by taking a derivative action (articles

33 of the Quebec *Code of Civil Procedure* and 316 CCQ), which opens the door to remedies similar to those under sections 239 and 241 of the *Canada Business Corporations Act* (including the oppression remedy).

The laws of some states in the U.S. allow the rules relating to the potential liability of directors to be limited in the case of directors who are not part of a smaller group of directors who in practice carry out all the duties of the board. This is not the case under the above-mentioned federal and Quebec statutes.

Precautions and corporate governance

As the legal provisions regarding directors of for-profit companies and directors of NPOs are so similar, it is not surprising that most of the **case law** involving for-profit companies applies to NPOs, with the **necessary adaptations**.

Similarly, the **rules and guidelines of the Canadian Securities Administrators** (CSA) applicable to reporting issuers constitute examples of best practices on **which NPOs can and should base themselves**, while making the necessary adjustments.

In the *Wise case*, the Supreme Court of Canada clearly stated that "the establishment of good **corporate governance rules** should be a **shield that protects directors** from allegations that they have breached their duty of care".

On this issue, readers are encouraged to read prior newsletters by the author, including the November 2005 newsletter entitled "Corporate Directors: Suggested Precautions" and the July 2005 newsletter entitled "The New Corporate Governance Rules and Guidelines".

Insurance coverage and indemnification

Section 90 of Part I of the *Companies Act* applies by reference to the directors of NPOs incorporated under Part III of the same Act.. That section reads as follows:

"90. Every director of the company may, with the consent of the company, given at any general meeting thereof, be indemnified and saved harmless out of the funds of the company, from and against all costs, charges and expenses which he sustains or incurs in or about any action, suit or proceeding which is brought, commenced or prosecuted against him, for or in respect of any act, deed, matter or thing made, done or permitted by him, in or about the execution of the duties of his office, and also from and against all other costs, charges and expenses which he sustains or incurs, in or about or in relation to the affairs thereof,-except such costs, charges or expenses as are occasioned by his own fault."

⁵ EYB 2006-100768. See our May 2006 bulletin on this subject entitled "A recent Quebec Court of Appeal decision involving extra-contractual liability of directors".

⁶ Sections 256 and 260 of the *Consumer Protection Act R.S.Q.*, c. P-40.

The language used in this section differs from that of section 123.87 of Part IA, which applies to business corporations. However, section 90 allows directors to be indemnified in most cases, provided the NPO gives its **consent** at a **general meeting of its members**.

Section 93 of Part II of the *Canada Corporations Act* also provides for the possibility of the directors being indemnified if the meeting of the members gives its consent. However, in the case of deliberate or gross **fault**, and in certain cases of ordinary fault, indemnification is not available.

It is therefore important that directors ensure that a **by-law is validly adopted by a meeting of the members**. Several comments made in our newsletter entitled "Directors' Liability, Indemnification and Insurance Coverage" (published in November 2005) are relevant. The language of both the by-law or resolution and the indemnification agreement must be **adapted to comply with the constituting act**.

3. SOME DIFFERENCES

The fact that a company is «not-for-profit», the nature of its activities and, very often, the lack of funding and human resources, create a particular environment for directors of NPOs. Also, in performing their duties, directors must take into account certain differences resulting from, among other things:

- the **objects** of the NPO
- for many NPOs, the notion of **required representation**
- the meaning to be given to the expression "**interest of the legal person**"
- the role associated with **donations and grants**

Objects

An NPO is generally incorporated under Part III of the Companies Act by letters patent which grant the NPO a **charter for the objects listed therein**. The objects are thus explicitly defined in the charter and, although they are generally worded quite broadly, they are **limited**, whereas in the case of most certificates of incorporation granted to **for-profit companies**, there is no limit on their objects.

Directors who allow an NPO to pursue objects which are not authorized by its charter or articles of incorporation may therefore breach article 321 CCQ, which requires that they comply with the constituting act.

Directors of an NPO therefore have an interest in understanding the scope of the objects and ensuring that the NPO's plans and activities do not exceed the scope of its objects.

Although, in practice, **exceeding the scope of the objects** does not normally have any consequences, it is possible that **third parties harmed** by the actions or statements of an NPO institute **legal proceedings** against the NPO and its directors who encouraged or supported the actions or statements.

Representativeness

Many NPOs adopt **by-laws encouraging the election as directors of people from certain interest groups or geographic areas**.

In fact, this is not a great difference, as some shareholders also try to have this type of representation on the boards of business corporations. However, in the case of NPOs, this requirement is found in the general by-laws or letters patent, whereas in the case of business corporations this type of representation is generally required or agreed to in the shareholders' agreement.

When duly authorized or permitted and adequately worded, these rules regarding representation are perfectly legal. Once elected, however, a director/representative may not protect the interest of the person who proposed him unless that interest corresponds to the best interests of the NPO. A director is a **mandatary of the company rather than of the person who proposed him**.

In the case of NPOs with required representation, the directors must therefore be especially cautious in discussing topics where the view or, more specifically, the interests of the persons who proposed them and those of the NPO diverge. Thus, a director/representative of an employees' union of an NPO must abstain from voting on any issue regarding the negotiation of the collective agreement or employment conditions and preferably also abstain, in most cases, from participating in discussions of these matters.

We discussed the problems and conflicting loyalties which director/representatives face or could face in a newsletter entitled "The 'Nominee' director and conflicting loyalties" published in June 2006. In it you can find certain suggested precautions which, in most cases, are also relevant for directors of an NPO.

Interest of the legal person

Whereas most companies are incorporated for financial or business purposes for the benefit of their shareholders, NPOs are incorporated for purposes which have nothing to do with monetary gain, although an NPO may carry on commercial activities.

Directors of both NPOs and for-profit companies are **required to act in the interest of the legal person**. In the case of for-profit companies, the interest of the company is or may be significantly different from that of certain shareholders. Similarly, in the case of NPOs, **the interest of the NPO is or may be different from that of its members**.

Furthermore, **in practice**, in the case of a for-profit company, and taking into account the profit motive, the relationship between the interest of all the shareholders and the interest of the company is usually close, if these interests are not exactly the same. Also, in the case of companies which are reporting issuers, the case law has clearly recognized that in the case of a takeover bid, the interest of the company should be interpreted as the financial interest of all its shareholders⁷.

The relationship between the interest of its members and that of an NPO is far from being as close, except in the case of an NPO having the object of protecting its members or providing services to them (i.e. NPOs described in common law as "membership organizations"). As an NPO has one or more objects, unlike most business corporations, the **relationship between such object(s) and the interest of the NPO is much more significant** than the relationship between the interest of all the shareholders and that of the corporation.

In other words, a director of an NPO must constantly ask himself whether a proposal or project is in keeping with the objects or purposes of the NPO and not whether the proposal or project meets the requirements of the members at the time or the current ambitions of the officers or the chairman of the board, or of a donor or funding agency (other than legitimate contractual requirements).

Donations and grants

Many NPOs receive donations or grants. Although in Quebec law the directors of such NPOs are **not the trustees of such donations and grants or of the donors or funding agencies**, contrary to, for example, what is prescribed in Ontario's *Charities Accounting Act* and certain common law precedents or rules⁸, often the donors or funding agencies attach **conditions** to their donations or grants which the NPO agrees to fulfil. Even in the absence of conditions, the donations or grants are normally paid based on statements by the NPO regarding the destination or intended use of the funds received.

A director's duty of care undoubtedly includes oversight of the management and use of donations and grants. Furthermore, the Supreme Court of Canada's above-mentioned decision in the *Wise* case confirmed that the duty of loyalty is not for the benefit of a company's creditors.

Nonetheless, the failure of a director to fulfil his duty of care with regard to the management and use of grants could open the door to legal proceedings by the donors or funding agencies in certain circumstances.

⁷ See, for example, *NDC Corporation v. Regal Greeting Gift Inc.* (1994) 17 O.S.B.C. 4971 and the policies of the CSA.

⁸ R.S.O. 1990, Chapter C-10.

CONCLUSION

Directors of NPOs are subject to substantially the same duties as the directors of for-profit companies and they **should not underestimate the risk of liability** resulting from the performance of their duties. The milieu in which NPOs operate is often more fertile ground for conflicts than that of for-profit companies. Directors should therefore take the precautions available to them (prior checking of information, indemnification agreements, adoption and implementation of sound corporate governance practices, etc.). As we have often said, the **best precaution** directors can take is to **comply with the duties of diligence and loyalty** imposed by law and the courts.

In the cases of both NPOs and for-profit companies, the board of directors is responsible for managing the company. Delegating the day-to-day management to officers does not release the board from its obligation to oversee such management and to fulfil its other duties, including those relating to strategic planning, risk management, succession planning and the implementation of a culture of integrity. A director cannot adequately fulfil such duties without reading the documents and attending and actively participating in meetings by asking questions and expressing points of view.

A person who agrees to be a director of an NPO should not consider his role to be an honorary one or think that his obligations are limited to giving or collecting money or providing advice to its officers. All directors have the same duties and are ultimately subject to the same liabilities, although there may be differences or increased burdens based on their skills, knowledge and various additional responsibilities.

In closing, we would suggest that the fact that all directors are treated equally under the law and that effectiveness is essential clearly suggests that boards made up of a large number of directors are not advisable.

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