



# Crease Harman & Company

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## **Directors and Officers Liability for Non Profit Entities**

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### **Introduction**

More than 80% of Canadians report volunteering in some capacity for a non profit organization. Of these people, over 40% of them hold positions on boards or committees. In most cases, without thinking much about it, these people have accepted a degree of legal liability for the actions of their organization under their control.

Forty years ago, few Canadians would have thought of ever suing a group of volunteers, except in the most egregious circumstances. Today, however, the Canadian public is expecting non-profit organizations, and those who run them, to more accountable and business-like in managing their affairs.

The following information has been provided to inform board members of their legal responsibilities as well as to provide practical suggestions for managing these risks and minimizing liability. While the information being presented contains some legal information, it does not provide legal advice. Legal advice will vary with the individual situation, and depend in part on the nature of the volunteer organisation.

### **What is a Director?**

A director is an individual who is a member of a governing board of an organization. This organization can be “unincorporated” and thus have no legal status, or it can be “incorporated” as a corporation under federal or provincial statutes. This corporation can be for-profit, organized to pursue commercial objectives, or it can be non-profit, organized to fulfill benevolent or charitable purposes.

Organizations come in a variety of types and sizes, under a variety of names. A non-profit organization can be referred to as a club, association, society, corporation, league, or committee.

If the organization is incorporated, the directors will be formally appointed under a statutory procedure, and the names of the directors will be registered with a public agency. The incorporation of a society under a federal or provincial statute establishes the organization as a legal entity (an “artificial person”) that exists independently as separate and distinct from its members. This legal entity can:

- Own property in its own name
- Acquire rights, obligations and responsibilities
- Enter into contracts and agreements
- Sue and be sued as if it was a real person

An unincorporated organization is not a society in the sense that it has no separate legal entity and has no legal status apart from that of its members. For example, an unincorporated entity cannot:

- Enter into contracts of its own. What that means is that the directors or officers who execute the contract on behalf of the organization might be held to that contract in their personal capacities.
- Be sued as an organization. However directors either collectively or individually, can be sued by a third party.

## **What is a Board of Directors?**

Most organizations are governed by either an administrative/“hands-on” board or a policy-governing board. In most cases these boards are more commonly known as a board of directors, a board of governors or a board of trustees.

The primary responsibility of this board is to provide leadership and direction to the organization, and to govern its affairs on behalf of members (or shareholders, in the case of companies).

Directors are usually elected or appointed to their positions on the board. Directors may also be officers, where an officer fulfills certain corporate roles and functions, such as those duties of a “president”, “treasurer” or “secretary” of the organization. Officers can also be senior staff persons, and in rare circumstances, staff persons can also be directors.

## **What are the Legal Duties of Directors?**

The basic responsibility of directors is to represent the interest of the members in the directing the affairs of the organization and to do so within the law.

In representing the members of the organization and acting as their “trustee”, directors have three basic duties:

### *1. The duty of diligence.*

Directors and officers generally must act with the care that a reasonably prudent person in a similar position would use under similar circumstances. They must perform their duties in good faith and in a manner they reasonably believe to be in the best interest of the corporation. Prior to making a business decision, D&O's must inform themselves of all material information reasonably available to them.

**Informed Decisions:** This duty requires not only reasonable behavior with respect to matters submitted for approval, but also requires reasonable inquiry and monitoring of corporate affairs. Although directors and officers are not insurers of the integrity of their subordinates or of general organizational performance, they are required to implement reasonable programs to promote appropriate organizational conduct and to identify improper conduct.

For larger societies, this includes the duty to implement reasonable programmes and policies to promote good conduct, and to identify and prevent improper conduct.

In the United States, and increasingly in Canada, this duty of diligence may be higher for D&O's of charitable or other types of non-profit entities. The higher standard of care is similar to the high fiduciary duty owed by trustees to beneficiaries of the trust they administer. The justification for this higher standard is the perception that the non-profit D&O's are entrusted with assets and responsibilities for the benefit of people who have little or no input into the selection of the D&O's

### *2. The duty of loyalty.*

This is the duty place the interests of the organization first, and to not use one's position as a director to further private interests. This duty requires directors and officers to refrain from engaging in personal activities which would injure or take advantage of the organization. They are prohibited from using their position of trust and confidence to further their private interests. This duty requires an undivided and unselfish loyalty to the organization and demands that there be no conflict between one's duty to the organization and self-interest. Examples of prohibited conduct in this regard include:

- D&O's may not realize secret profits or unfair gain through personal transactions with or on behalf of the Organization.
- D&O's may not compete with the organization to its detriment.
- D&O's may not usurp an opportunity of the organization.
- D&O's may not realize personal gain from the use of material, nonpublic information.
- D&O's should avoid even the appearance of a conflict of interest.

### *3. The duty of obedience.*

This is the duty to act within the scope of the governing policies of the organization. Directors and officers are required to perform their duties in accordance with applicable statutes and the terms of the organization's bylaws and constitution, and can be personally liable if they authorize an act which is beyond a society's powers.

This is a particularly acute issue for older societies, which tend to have very restricted purposes, and for charities, which are prohibited by law from undertaking any significant degree of advocacy work or political organizing.

## What Types of Liability can Directors Face?

A director who fails to fulfill his or her duties as outlined above may be liable. The term “liability” refers to the responsibility for the consequences of conduct that fails to meet a pre-determined legal standard. Usually, the term “consequences” refers to damage or loss experienced by someone, and being responsible for such consequences means having to pay financial compensation.

Liability arises in the following four situations:

1. *Statute* – a law is broken. The consequences are payment of a fine, having restrictions placed on one’s rights or privileges, or imprisonment.
2. *Contract* – a contract is breached or violated, where a contract is a legally enforceable promise between two or more parties. The consequences are correcting the breach through some form of performance or service, or financial compensation.
3. *Tort* – an act, or a failure to act, whether intentionally or unintentionally, causes injury or damage to another person. The consequences are payment of a remedy in the form of financial compensation.
4. *Wrongful Acts* – these are errors, omissions, actions or decisions that harm others, not through damaging their property or their physical person, but through interfering with their rights, opportunities or privileges.

## Limiting Liability

Incorporation is the first step in limiting liability, because it removes personal liability from directors, except for decisions made in bad faith.

Indemnification is the next step, in which the organization agrees to indemnify its directors in the event that they are found personally liable. It is almost universal practice for non-profit organizations to “indemnify” their directors for liabilities that they might incur in carrying out their duties as a director. To “indemnify” means to put someone back in the same financial position as they were in before. An indemnified director would be compensated for legal fees, fines that were paid under a statute, a financial settlement that resulted from a lawsuit or any other legal obligation that a director required to fulfill.

Of course, an indemnity is only as good as the organizations ability to back it. In cases where this is suspect, or the risk is intolerable, directors liability insurance is usually recommended. This is the third common step in limiting liability concerns.

## General Principles of Directors and Officers Liability

As mentioned above directors and officers are subject to three basic duties in performing their responsibilities. In addition, this section looks at the Business Judgment Rule which is an excellent "test" of an individual decision. This applies to directors of incorporated non-profits, when the party with a claim against that no profit is seeking to sue individual directors. If a decision can meet the criteria posed by the [Business Judgment Rule](#), then you will have an excellent defense against a directors and officers claim.

If you can show that the Business Judgment Rule applies to a decision, then the directors are *presumed* to have acted properly and to have satisfied the three basic duties (diligence, loyalty, obedience). The BJR recognizes that not all decisions of directors will result in benefit to the organization and that directors will be personally liable for loss to the organization only if the elements of the defense are not satisfied.

To obtain the benefit of this important defense, directors must act in good faith and with a reasonable basis for believing that their conduct is in the lawful and legitimate furtherance of the organization's purposes and must exercise their honest business judgment after due consideration of what they reasonably believe to be the relevant factors.

### Five elements of the BJR are generally recognized:

<b>1. Business decision.</b>
<b>2. Disinterestedness</b>
<b>2. Due care.</b>
<b>4. Good faith.</b>
<b>5. No abuse of discretion.</b>

### 1. Business decision.

The BJR protects directors against claims for wrongful acts, but not against claims for failure to act. Inaction by directors is protected by the BJR only if it is a result of a conscious decision to refrain from acting. **Inaction is not a defence, there must be a conscious design not to act.**

### 2. Disinterestedness.

The BJR protects directors who are disinterested and independent with respect to the challenged action. For this purpose disinterested directors are those who neither appear on both sides of the transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which inures to the corporation or all the stockholders generally.

### 3. Due care.

The BJR protects directors if they reached an informed decision after making a reasonable effort to ascertain and consider all relevant information reasonably available to them and after reasonably deliberating the decision.

### 4. Good faith.

The BJR protects directors if they acted with a good faith belief that their business decision was in the best interests of the corporation. The protection will not apply if the directors acted solely or primarily to preserve their positions or otherwise to benefit themselves.

### 5. No abuse of discretion.

The BJR protects directors against honest errors of judgment, but does not provide protection for decisions that cannot be supported by some rational basis and are egregious on their face.



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### Examples of Recent US Cases:

- In August 2003, a former employee of the Neighborhood House Association sued the association and its executive director for sexual harassment. The former employee alleges the executive director created a sexually hostile work environment by commenting on her body and attire. The former employee also alleges that the executive director began to discriminate against her when she would no longer tolerate his inappropriate comments and conduct and finally discharged her in retaliation against her. The former employee requests over \$1 million in damages.

- *Bell v. Presbyterian Church (USA), et al.*, 1997 U.S. App. LEXIS 26994 (E.D. Va. 1997). The Reverend James Bell, former Executive Director of Interfaith Impact sued four religious organizations and the Board of Directors of Interfaith Impact alleging interference with his employment contract, intentional infliction of emotional distress, breach of a covenant of good faith and fair dealing, interference with his prospective advantage, wrongful termination and breach of a pledge to contribute to Interfaith Impact on yearly basis. Bell's employment had been terminated by Interfaith Impact's Board of Directors due to a reduction in the work force for economic reasons.

- *Burke, et al. v. the Tennessee Walking Horse Breeders and Exhibitors Association, et al.*, 1997 Tenn. App. LEXIS 378 (May 28, 1997). The plaintiffs, members of the association, filed suit against the association and its Executive Committee to invalidate an election of the Board of Directors to the Association. The plaintiffs alleged the association bylaws provide for the election of the Executive Committee to take place at the annual December membership meeting. Under the bylaws, the cut-off date for ballots was October 15, 1996. The plaintiffs alleged that the voting procedures outlined in the bylaws were violated because ballots placed in the box on October 16 were collected on October 17 and mixed with ballots placed in the box on or before October 15. The plaintiffs also alleged that the Executive Committee wrongfully ratified the Election Committee report, the Executive Committee and the Executive Director willfully disregarded the bylaws and breached their fiduciary duty. The plaintiffs requested a new election and a judgment against the Executive Committee for costs of the lawsuit and costs of a new election. The trial court dismissed this matter on summary judgment which was upheld by the Tennessee appeals court. The appeals court held that the plaintiffs' membership established the requisite substantial property interest in order to have standing to assert an action for declaratory judgment. Nonetheless, the actions of the Executive Committee were presumptively taken in good faith and with reasonable grounds and plaintiffs had brought forth no evidence to negate the presumption. The court also held that while members of nonprofit corporations have the right to bring derivative actions, the plaintiff's complaint was inadequate because it contained no statement that the relief sought would result in a financial benefit to the corporation or to the plaintiffs.