Conflicting Loyalties

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The proclamation of the *Canada Not-for-Profit Corporations Act* (*CNCA*) last October marks a major updating of several aspects of governance for federal non-share corporations. It incorporates welcome refinements to existing law related to director liability and offers a statutory due diligence defence against alleged breaches of duty of care by directors. However, one area where the new statute isn't much help is in dealing with conflicts of loyalty.

Like its predecessor statute, the *Canada Corporation Act* (*CCA*), and equivalent legislation at the provincial level, the *CNCA* focuses on pecuniary conflicts of interest. While from time-to-time a director of a charity or not-for-profit organization may have a material interest in a contract or other business dealing in which the corporation is involved, it is probably more frequently the case with charities and not-for-profits that potential conflicts arise owing to a director or officer feeling or acting on a loyalty to a group other than the charity or not-for-profit corporation.

As with the *CCA*, under the *CNCA* a director is obliged to act in the best interests of the corporation. The courts have held that one element of a director's fiduciary duties is a duty of loyalty. This includes:

- disclosing any dealings with the corporation and actively avoiding impropriety or dishonesty;
- giving full allegiance to the corporation's mission;
- resigning where personal prejudices or beliefs inconsistent with that mission might interfere with duties owed to the corporation;
- respecting confidentiality; and
- supporting execution of board decisions.

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The ability to put one's personal and other interests aside when acting as a director is essential to being able to fulfil this duty.

Conflicts of loyalty usually arise where, in considering a matter, a member of a decision-making body owes a duty or is influenced by an affiliation with an entity for which the matter is being decided. An affiliation may be formal or informal.

Sometimes an apparent, rather than actual, conflict of loyalty will exist because the decision-maker owes a duty or has an affiliation to different groups, but the interests of the groups co-incide rather than diverge. In such a case, there may technically be no reason for directors to remove themselves from consideration of the matter. However, concern over public perceptions may cause organizations to insist that they do so.

The "best interest of the corporation" test used in the *CNCA* was developed largely in the context of for-profit corporations, and historically was associated with acting in a way that essentially maximized shareholder financial return. In the last few years, however, the Supreme Court of Canada has opened up more scope to consider the impact of board decisions and corporate conduct on stakeholders other than shareholders. *Peoples Department Stores Inc. (Trustee of)* v. *Wise*, [2004] 3 S.C.R. 461, 2004 SCC 68 and *BCE Inc.* v. *1976 Debentureholders*, [2008] 3 S.C.R. 560, 2008 SCC 69 both deal with not equating the best interest of the corporation strictly to maximizing return to shareholders .

This does not mean that directors can now exchange the traditional "best interests of the corporation" test used for board decisions with an approach focusing wholly on the needs or desires of specific constituencies. Instead a balancing is called for. In taking decisions, directors can give some – not exclusive – consideration to interests beyond those of shareholders.

How far this extends, or how it applies, to incorporated charities and not-for-profit organizations remains little explored by the courts, and is generally not contemplated at all in the legislation under which these groups are established and operate.

In practice, some charity and not-for-profit corporations structure themselves in a way that is at odds with director independence from the start. Many groups are constituted on the basis that various stakeholder groups will be "represented" on the board of directors.[1] Sometimes boards are made up exclusively of directors chosen by the organization's core constituencies. The composition of the boards of foundations associated with institutional charities, such as universities and hospitals, typically includes directors and/or staff of the institution.

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Other groups may open the door to potential conflicts when, as operating charities or not-for-profits, they include funders on their boards, or as funders seek directorships of operational groups. Sometimes two organizations will agree, as part of a strategic partnership or other collaboration, to cross appointments, believing that this will assist in their working together.

Regardless of how such relationships arise, they are a reality in the charity and not-for-profit sector. Indeed, they are likely to become more common in the face of economic pressures, increasing stress on partnership and the popularity of collaborative work among the young. In small communities, where the volunteer pool is sometimes quite limited, some crossover may be inevitable. So, given that there is a limited legal framework to provide guidance on how this issue ought to be handled, it falls to individuals and organizations to find how best to deal with it.

At the organizational level a number of measures can be taken.

- A good first step is not to set up a governance structure where directors or other decision-makers are likely to be influenced by external affiliations or loyalties whenever faced with a decision.
- If it is considered essential or desirable for particular constituencies to have a say in organizational strategy or direction, one alternative is to set up an advisory council or other mechanism for these stakeholders to influence the mandate or work of the group.
- Board members can also be given responsibility for liaising with constituencies and reporting on feedback from stakeholders as part of the board's regular agenda.
- The organization can also endorse on-going staff-to-staff dialogue.

It is not always possible to adopt a governance model where stakeholder representation is rejected. Indeed, sometimes the composition of a board is mandated by the legislation under which an organization was established. For example, a statute might provide for representation of particular constituencies on a body overseeing a port or airport. In another context, if an organization

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has a long-standing policy of staff representation on its board, it may not be feasible to alter that practice.

Even where there is no imperative or history of recruiting board members with external affiliations, directors may still face situations where competing loyalties arise as the organization and the composition of its board evolves. In such situations, having a written policy:

- helps directors determine what the organization considers a conflict of loyalty and sets out the procedure for dealing with conflicts when they occur;
- helps the organization to assess conduct based on principles rather than situations; and
- helps the organization deal with circumstances that arise repeatedly. For example, a funder may as a matter of practice occasionally seek an opportunity to serve on the board of an organization it funds – perhaps to provide expertise that the organization couldn't obtain easily elsewhere. It may do so without necessarily wanting to scrutinize how the funding it provides is used. The policy can set out expectations about the status of such directors during funding decisions; for example, not participating in the deliberations when funding is under discussion.

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More generally, it may make sense to incorporate procedures for dealing with conflicts of loyalty into the organization's policy regarding pecuniary conflicts of interest since there are often similarities between how these two types of conflicts are identified and treated, and in protocols for responding to the failure of a director to disclose a conflict.

As conflicts of loyalty may be tricky to recognize, it may be useful to have a procedure for a board member who thinks he or she may face a conflict to obtain advice. Establishing a protocol for a board chair or board member other than the conflicted director to raise a potential conflict, rather than having matters brought up on an *ad hoc* basis, may improve board dynamics. Since in many situations there may not be an adverse interest as between the organization and the entity to which the director has another loyalty, the policy should also set out whether any recusal requirements or other processes apply when the conflict is apparent rather than actual.

Another element of the policy that should be considered is the reporting and remedying of failure to disclose or deal appropriately with a conflict. As well as legal consequences that apply, organizations may wish to impose other sanctions. Although typically the laws under which charities and not-for-profit organizations are constituted do not permit removal of directors except through a special resolution of the members, the policy can provide for the directors triggering a general meeting of members to consider the conduct or taking other measures to express disapproval.

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Legal penalties and organizational measures, however, can only go so far in dealing with these types of conflicts. Cases where directors clearly have legal duties to two groups that conflict with each other are rare. Much more common are situations where the director has a legal duty to act in the best interest of a corporation but has some formal or informal affiliation that calls in question whether his or her decision-making could potentially be clouded by divided loyalties.

The person often best-placed to make a determination of whether inappropriate external factors are apt to be taken into account when a matter is considered is the director himself or herself. So, inevitably, boards have to rely on directors policing themselves, rather than trying to regulate their conduct. Given this, orienting directors to be alert for potential conflicts and encouraging board members to hold colleagues accountable for acknowledging and dealing with conflicts is crucial. All the more so, since the Supreme Court has erased any bright line test for conflicts of loyalty.

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It is perhaps not reasonable to expect the *CNCA* or similar statutes to provide a definitive answer on every governance question. That said, it is rather unfortunate that something so fundamental to how many charities and not-for-profits operate is not well dealt with anywhere in law.

We can hope that, over time, the courts will offer clearer guidance on how conflicts of loyalty ought to be handled. However, given the limited case law in many other areas of charity and not-for-profit law, the likelihood is that organizations and directors will need to find their own way on this issue for the foreseeable future.

Notes

1. See Clifford Goldfarb, "Dual Loyalties on Non-Profit Boards: Serving Two Masters", a paper presented earlier this year at Canadian Bar Association 2011 National Charity Law Symposium (Toronto: May 6, 2011).

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