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**Report on  
Conflicts of Interest:  
Directors and Societies  
Volume II: Consultation**

MINISTRY OF ATTORNEY GENERAL

**LAW REFORM COMMISSION  
OF BRITISH COLUMBIA**

**REPORT ON**

**CONFLICTS OF INTEREST:**

**DIRECTORS AND SOCIETIES**

**(VOLUME II: CONSULTATION)**

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“The Commission is to take and keep under review all the law of the Province, including statute law, common law and judicial decisions, with a view to its systematic development and reform, including the codification, elimination of anomalies, repeal of obsolete and unnecessary enactments, reduction in the number of separate enactments and generally the simplification and modernization of the law...”

*Law Reform Commission Act*  
**Statutes of British Columbia, 1969**

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LRC 144

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The Law Reform Commission of British Columbia was established by the *Law Reform Commission Act* in 1969 and began functioning in 1970.

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**1.1 Introduction**

1.1.1 Chapter III in Volume I of this Report summarizes the main themes that emerged in the process of consultation. The Commission's recommendations for reform are set out in Volume I. This Volume provides a much more thorough-going review of the very detailed comments the Consultation Paper ("CP") attracted. The comments serve as a point of departure for a substantive exploration of the issues.<sup>1</sup>

1.1.2 The comments we received were invaluable. It prompted re-thinking on numerous issues. The Commission is indebted to all of those who took the time to write, e-mail, telephone, or meet with staff members and comment on the suggestions for changing the law set out in the CP.

**1.2 Comment**

1.2.1 As expected, comments were divided. Opinion split on the following issues:

- what should be characterized as a conflict of interest?
- is there a problem at all?
- if there is a problem, what are useful ways of addressing it?

Despite the support the suggestions for change attracted, persuasive arguments were raised in favour of amending various points of detail.

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1. This Volume is intended to complement Volume I of the Report and the CP and does not attempt to summarise all points already canvassed in those documents.



### 2.1 Those Who Agreed the Law Should be Changed

2.1.1 Whether or not people agreed with the suggestions for reform corresponded almost exactly with their views about whether any problem existed at all. Those who encountered conflicts of interest issues when participating in societies wanted tougher rules. Most agreed the law should be changed.

2.1.2 Here is a sampling of comments from those favouring new rules:

- It has been my experience sitting at board level with several different charitable societies that for the average well meaning volunteer, there can be confusion around the issue of conflicts of interest. Board members may have a tendency to unknowingly or unintentionally make decisions that could put the society at risk. A conduct code reduces such a risk.
- ...Many volunteer board members have the best of intentions and genuine interest in the work of their society. The problem as I see it is that many volunteer board members do not have a strong business background and therefore do not understand the full implications of conflicts of interest and for this reason the *Society Act* must give clear direction.
- If I, as a lawyer, had some difficulties with the question of whether or not I could, as a director, benefit from a transaction with the society, then I expect other directors without legal training would experience greater confusion. The Law Reform Commission's proposal would, in my opinion, simply minimize the likelihood that any conflict of interest would arise. That it would effectively require lawyers, like myself, who sit as directors to resign before they provide legal services to the society is the cost of ensuring that the broader public interest is protected.

2.1.3 Some societies have already voluntarily adopted stricter standards for their directors:

I agree that revisions to the law are required; the Society of which I'm a Board member has already enacted its own policies which are stricter than those in the Act, and I believe many other Societies have done the same.

We also heard from societies that were inspired by the CP to adopt conduct guidelines and based them on the draft published in the CP.

### 2.2 Those Who Would Go Further: Zero Tolerance

2.2.1 A few people thought the suggested changes did not go far enough. We were urged to endorse legislation that would not tolerate a director having any conflict of interest.

2.2.2 When the CP was prepared this idea was explored but rejected. Not all conflicts of interest lead inevitably to bad results. Some transactions touched by a conflict of interest are, nevertheless, in the best interests of both the society and the public. This point is explored in more detail in this Volume, particularly in Chapters III and VI.

### 2.3 Reasons For Not Revising the Law

2.3.1 Some argued that the law should not be changed. This section examines the reasons advanced in support of this view. The reasons divided into two categories:

- there is no problem and therefore no need to change the law
- even if there is a problem, there are practical reasons for keeping the current rules.

### 2.4 Is There a Problem?

2.4.1 The main reason put forward in the CP for changing the law was the need to prevent director self-dealing. Not everyone agreed that director self-dealing is a problem. Two points of view emerged from comments we received:

- there is no problem because directors of societies do not self-deal to any significant degree
- there is no problem because there is nothing wrong with director self-dealing.

## 2.5 Do Director's Self-Deal?

2.5.1 Those who told us that directors do not self-deal, or viewed the problem as one of limited extent, argued that the CP had failed to produce any convincing evidence of self-dealing:

- I find of interest your comment...“There does not appear to be any authority on [section 29 of the *Society Act*].”

...Even given the cost and difficulty with litigating conflict of interest questions, one would think that if the problem was as great as Mr. Hughes [the Conflicts of Interest Commissioner] suggested there should be at least some law on this section...<sup>2</sup>

- The perceived problem appears to be over-rated and seems to have grown out of a media led concern over alleged conflicts of interest among politicians.
- Despite the length of its report, the LRC provided very little hard evidence that there is a problem which is not already covered by some other means. For one thing, if a society doesn't like what a member is doing, it can remove the member at the next general meeting. We don't think it makes sense to try to legislate remedies to situations where someone might feel intimidated by someone else. Furthermore, despite some LRC arguments to the contrary, we feel ethics, conduct and directors' responsibilities are already well covered by the *Society Act*. Other remedies are contained in the *Criminal Code*, the *Company Act* and other existing legislation, as well as in common law and an organization's own code of ethics.

We feel the LRC relied too extensively on hypothetical situations to reach its conclusions. And when anecdotal facts were used - such as the 34 examples of conflict detailed in Appendix D - in almost every case, they were irrelevant to the proposed legislation because they already were covered by other statutes. In most of the examples, the conflict was based on either one of two things:

- someone was not carrying out his or her fiduciary duty, which is clearly dealt with by the *Society Act*; or
- it involved fraud which is of course covered by the *Criminal Code* of Canada.

In other words, in almost every case cited by the LRC, society is already well protected.

A number of points are raised in these submissions, but a close reading of them suggests only one basic premise: absent evidence of a problem there is no problem. We dispute the premise.

2.5.2 It is reasonable to expect that problem areas will produce visible signs, but there are many reasons why such signs might be sparse. Not the least of these is that matters may be resolved privately. Moreover, there is a great deal of evidence of problems flowing from self-dealing, even if the evidence is predominately anecdotal. To some extent we tapped that vein of personal experience in responses to the CP. The support the CP suggestions received provides at least some evidence of a need to make changes to the existing law. Many people shared with us their concern that board decisions, and the actions of individual directors, do not always promote the society's best interests.

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<sup>2</sup> The author of this comment may have misapprehended the legal position. There could not possibly be litigation under s. 29 in connection with a transaction authorized in accordance with the *Society Act* rules. Any transaction authorized under the Act is immune from attack under s. 29. This was central to the point of concern addressed in the CP: transactions are being “validly” authorized that should not be.

2.5.3 It is true that much of the available evidence of a problem in this sphere is based on larger examples of abuse, ones that attract headlines, the few that involve amounts of money so significant between people so unwilling to compromise that there is a trial and a reported judgment.<sup>3</sup> Most cases of conflict of interest, not surprisingly, leave no public record. The conflict itself passes unnoticed or, if noticed, is tacitly approved or ignored. When concerns are raised, the matter is more often than not resolved through private, often informal, means:<sup>4</sup>

If there's something wrong in the not-for-profit sector, it's almost certain you won't hear about it from the people who work there.

You're more likely to get the story when it hits the papers, which is usually after a nonprofit organization has become such a mess that it either collapses or government has to step in. An executive director resigns, a public enquiry is held, sometimes a minister resigns. It often turns out staff knew there was a problem but nothing was done.

2.5.4 The main reason to expect little evidence of director self-dealing is that the current law allows it. Once an appropriate disclosure is made to the board, and the board gives its approval, no one can challenge the arrangement.

2.5.5 Consultation established that there is a problem. There is evidence of the problem. There is also substantial support for the view that the problem must be addressed.

## 2.6 What is Wrong With Director Self-Dealing?

2.6.1 Should the law allow directors to profit from their dealings with a society? We heard from some who had no difficulty answering "yes" to this question.

2.6.2 Some regarded business transactions between the society and a director as usually an essential part of carrying out a society's mission. Others saw it as the price for obtaining willing volunteers. An argument appearing in a number of responses was that small societies are formed by well-meaning people who use public funds to achieve important goals. It is simply a fact of life that these same people will be paid by the society to achieve those goals. Here is a sample of the comments on these points:

- There is one fundamental point on which we differ and that is we cannot support the premise that "a director must not enter into a transaction with the society." The proposed legislation explains that there are circumstances which should allow a director to conduct business on behalf of the Association and receive remuneration: however, the strength of the statement that a director should not enter into a transaction makes it impossible for us to support its inclusion.

In our organization, we feel that in order to stay current with the industry, we must be free to draw volunteers from all parts....We also feel that volunteers should not be penalized for their involvement with our organization.

- Your concerns are only addressing issues for large organizations already fully staffed and up-and-running. I feel your changes will cancel the future possibilities of founding small nonprofit organizations. Your recommendations have a bias against small charitable organizations. If you study the history of nonprofit organizations, you will find that the founders were frequently the initial staff. Your proposals would deny such initiatives the possibility of getting off the ground.

- In your consultations we hope you will appreciate the problems facing societies such as ours which exist in small villages, where available people to work on a project are extremely limited. All too often the people with the specific skill and interest required for our...projects are the active members of our society.

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3. The phenomenon is not confined to societies. The same principles limit court proceedings in disputes arising with respect to the internal management of companies: *see, e.g.*, F. Le Grys, "Controlling directors' remuneration," (1995) 139 Sol. J. 96.

4. C. Howard, "Non-profit organizations often struggle with internal power issues," *Globe and Mail*, November 29, 1994 A22. One might expect disgruntled ex-employees to speak up, but even this is uncommon, possibly because in many cases there will be a settlement enjoining the employee from talking about the agency: *ibid.* This is a common practice when disputes are settled. Most public and private organizations value their privacy. They do not wish controversial issues to receive public attention.

It is essential that we obtain the best people without being hindered by red tape. We note that you do plan some exceptions i.e.: “a transaction representing savings to the society so substantial that no other decision makes economic sense,” and “special cases where only the director can, or is willing to carry out the transaction.” We hope that you will retain these exceptions.

- We would like to be able to reward a volunteer who has worked for the association by allowing them to bid on contracts or even have them awarded contracts without a bidding process based on the circumstances. We recognize that this may allow for unscrupulous people to take advantage of Boards who are not as “business-smart” as they should be. That is why we favour the status quo with the recommendation of each association adopting model conduct guidelines.

2.6.3 Other correspondents, however, welcomed a revision of the law so that it would stipulate the ethical responsibilities of directors:

- At this time I simply wanted to express my support for this initiative. I have myself been a director of a nonprofit society when my services as a lawyer were requested. In those circumstances, I felt I could not act for the society, but would be willing to help the society retain legal counsel and be the spokesperson for the society with that lawyer....

The primary reason which prompted me to ensure that I would not be in a conflict of interest arose when I considered the fact that, had I remained a director and the society's lawyer, and had something gone wrong with the legal services I had provided, I would then be in the absurd position of trying to decide whether or not to sue myself.

2.6.4 For hundreds of years it has been recognized as a fundamental feature of human nature that even the best of us will bear watching when personal interests are involved. The law has evolved rules that require a person charged with looking after the interests of someone else to make sure personal interests do not enter the equation. It should not surprise anyone that there is also a need for rules responding to this aspect of human nature for people involved in societies. We do not deny, however, that there are some forms of beneficial self-dealing. The CP specifically set out exceptions in order to make sure they would still be allowed under revised law. These areas, and other suggestions made to us, are reviewed later in this Volume.<sup>5</sup>

2.6.5 Rules to avoid director self-dealing protect the society, but they also have another dimension. They safeguard public confidence. Funding bodies, contributors and members expect the society to apply public funds to stated objectives:<sup>6</sup>

[Their trust]...is likely to be undermined both by visible instances of self-dealing and by suspicions that undetected self-dealing occurs. Trust is likely to be fragile when one receives no economic benefit in exchange for one's cash or property. Additionally, donors and prospective donors, having come to distrust one nonprofit, may distrust comparable organizations as well.

2.6.6 The example of the start-up society, where the first directors are also its employees, is a troubling one. This may well be a familiar, even a customary, arrangement. It is our conclusion, nevertheless, that if the endeavour is worthwhile it will be able to attract the support of enough people who do not require a financial interest as a necessary inducement for participating in the enterprise. It must be possible to obtain impartial directors to see to the application of funds. The law should so require. If a society cannot be formed because of an absence of volunteers, that is, possibly, a sign the enterprise should be conducted as a commercial venture through a company.

2.6.7 Should a society be able to reward volunteers for their contributions to the society? Many people participate in nonprofit agencies with a view to gaining experience for a paid position. We

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5. Ch. III, *Allowable Transactions*.

6. Deborah A. DeMott, “Self-Dealing Transactions in Nonprofit Corporations,” (1993) 59 *Brook. L. Rev.* 131, 134.

accept the idea of rewarding the hard working non-director/volunteer in this way. Rules aimed at those who control the funds of the organization would not affect arrangements with non-directors.<sup>7</sup>

## 2.7 The Need for Workable Solutions

2.7.1 This section discusses the comments the CP attracted that focused not on whether the law should be changed, but deficiencies seen in the proposed reforms.

2.7.2 Some argued that no single conflicts of interest model could work for all societies. Not all societies are the same. They differ widely in size, resources, objectives, and functions:

...our association feels the LRC went too far with its blanket legislative proposal covering all 16,000 societies and other organizations.

This issue is pursued in Chapter IV of this Volume.

2.7.3 Some blamed failings in the current law on board members. If directors will not use the existing rules to guard against director self-dealing, it was argued, changing those rules cannot help:

- Don't the other board members have some responsibility to monitor and control these problems? And if they are not willing to properly discharge their responsibilities, I am not sure "helping" by drafting a new law that prevents in all cases such non-arms length dealings is the best approach.

To what extent can the law fix problems caused by the malfeasance and general lack of responsibility of the other board members?

Also, if the board is unwilling to stop such abuses, what reason should anyone have to believe they will not condone or permit similar abuses to occur when the beneficiary is an ex officio member or staff member?

- The Paper endeavours to explain why the existing statutory and common law rules are ineffective for societies as they do allow directors to contract with a society so long as the provisions of the *Society Act* are followed.

Our client disagrees that the present rules are ineffective if enforced properly. The problem is not the rules themselves, but the fact that they are not enforced to the degree to which perhaps they should be.

These comments are essentially correct. The current discretion, when applied appropriately, leads to appropriate results. We further agree that any solution must depend upon people discharging their responsibilities.

2.7.4 The object in establishing clearer conflicts of interest rules is not, however, the expectation that these will suddenly spur directors to new standards of ethical vigilance. Research suggests that many of the current problems stem from people simply being unaware of what constitutes a conflict of interest. Providing information about the standards expected from directors is bound to do some good. New rules might not mend the behaviour of the unethical. But new rules can tell an ethical director that transactions tainted by a conflict of interest must not be authorized unless there are very good reasons for doing so. New rules can also provide tools for identifying a conflict of interest, and for distinguishing between acceptable and unacceptable conflicts. New rules will assist directors who are anxious to do their jobs faithfully and well.<sup>8</sup>

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7. A business relationship with a director might be protected by having the director resign from the board while continuing to participate in the society. Resignation will not provide an answer in every case. There is nothing ethical, e.g., for a director to negotiate a sweetheart deal and then resign to take advantage of it. Such a transaction would violate the duty of loyalty the director owes the society.

8. It may, of course, be questioned whether a legislative statement as suggested in the CP is the best way of accomplishing this objective. Lawyers, and not all of them, may feel comfortable with legislation. Most people find it easily one of the clumsiest ways of imparting information. Because of the need to be absolutely precise in legislation, painstaking drafting often leads to very complicated expressions of ideas. This is particularly true for conflicts issues, where the questions are often not susceptible to a single answer. One problem, of course, is that any change must deal with legislation to a point, because the current position is

(continued...)

2.7.5 A review of factors that have sometimes made it difficult for board directors, society members and employees to control conflicts of interest effectively suggests that there is good reason to believe some of these impediments can be overcome by adopting clearer rules.

2.7.6 The number of factors pointed to at one time or another as decreasing the ability of a board of directors of a nonprofit to effectively protect the agency from conflicts of interest issues fall into two groups:

#### Factors affecting the original decision to authorize the transaction

- nonprofit boards are often homogeneous
- nonprofit boards make non-public decisions
- directors on nonprofit boards have different motivations from paid directors on for-profit boards
- directors have no benchmarks by which to assess whether conflicts of interests are serious
- boards do not make all operational decisions
- not all board members feel personally responsible for board decisions

#### Factors affecting a decision to allow an approved transaction to continue

- people feel a sense of complicity
- people want to protect their agency
- people involved in nonprofit agencies are often consensus-oriented
- people feel powerless to make a difference

The following sections discuss the significance of these factors.

#### 2.7.7 *Factors affecting the original decision to authorize the transaction:*

2.7.7.1 **Nonprofit boards are often homogeneous:**<sup>9</sup> Nonprofit agencies tend to attract supporters who have similar interests and share the same economic and social backgrounds.<sup>10</sup> People with similar backgrounds and interests often share the same kinds of values and think alike. Directors with much in common may tend to be less judgmental about one another and more inclined to allow director self-dealing.

2.7.7.2 **Nonprofit boards make non-public decisions:**<sup>11</sup> Decisions made by nonprofit boards are usually made in private and receive little formal publicity. Nonprofit boards tend to be less accountable than boards of companies because they do not have to answer to shareholders or others who have a financial interest in the agency. Lacking accountability, there is little incentive for vigilance:<sup>12</sup>

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8. (...continued)  
dictated by the provisions of the *Society Act*. But, as Volume I of the Report records, the Commission has concluded that it is possible to accomplish these objectives in alternative ways.

9. DeMott, *supra* n. 6, 140, n. 50. Societies providing services such as opera, museums, symphonies and theatres that are most often enjoyed by people with higher incomes and better education tend to have members who are well educated and well off. Societies serving distinct ethnic sectors of the population tend to have members from the sector they serve. Societies that provide services such as daycare tend to have members who are parents with young children. And so on. There would seem to be general agreement that the majority of directors on a board of a society that serves a particular sector should be drawn from that sector: see, e.g., J. Fisher, *Money Isn't Everything: A Survival Manual for Nonprofit Organizations* (1977) 37-9.

10. DeMott, *ibid.*

11. *Ibid.*, 139.

12. *Ibid.* In some, but certainly not all, cases, stakeholders such as clients of the nonprofit (those served by the nonprofit) are able to perform the same role of monitoring that shareholders perform for companies. So, e.g., parents of children enrolled in a daycare, or relatives of a resident of a nursing home, will be able to require accountability for some aspects of the nonprofit's activities. But, while similarities can be identified between stakeholders and shareholders, stakeholders usually occupy a less powerful position because they have less access to information: see, e.g., *infra*, n. 27, concerning restrictions on information available under freedom of information legislation.

There is ample reason to believe that the overall quality of directors' performance in the nonprofit sector is less than in publicly-traded, for-profit business corporations. First, because they do not issue publicly-traded investment securities, nonprofits are not subject to the extensive disclosure requirements, enforcement machinery and private litigation....Nonprofit directors thus make decisions in a less transparent environment and information about their decisions is not regularly exposed to the scrutiny of a broad audience. Their decisions on self-dealing questions typically become visible only in the wake of scandal.

**2.7.7.3 Directors on nonprofit boards have different motivations from paid directors on for-profit boards:** The motivations and viewpoints of directors serving on nonprofit boards may differ from those on for-profit boards.<sup>13</sup> An unpaid volunteer who, perhaps, contributes financially to an organization will often have a perspective on many issues that differs from that of a person who is paid to serve:<sup>14</sup>

...directors' motives and incentives for service on nonprofit boards differ dramatically from motives and incentives in the for-profit environment. Most nonprofits do not compensate their directors directly. Board members often join because they believe in an organization's mission and contribute to it with financial donations. They depend heavily on organization management to set the board's agenda and provide information to the board. Many large nonprofits also have relatively large boards. Some actors in this environment reportedly believe that directors who make financial contributions have a reciprocal entitlement to self-deal. Indeed the prospect of self-dealing may entice some directors to serve and to make financial contributions to the organization.

Directors may believe that volunteers (a) deserve some benefits from their labour and (b) cannot be held to the same standards as those who are paid. In this environment, a board may be inclined to favour self-dealing as well as excuse sub-standard conduct or ethical lapses.

**2.7.7.4 Directors lack benchmarks:** Often only time will tell whether a decision is a good or a bad one. Adding a conflict of interest dimension to the question does not make prophecy any less difficult. A transaction in which a director participates may, at first, appear to be beneficial to everyone involved in it. Only later, when the transaction turns sour, does the wisdom of having approved it become doubtful:<sup>15</sup>

...one of the biggest problems in the not-for-profit sector is the lack of a bottom line, that ultimate benchmark for private-sector accomplishment. "It's hard to measure what you're working toward... even good leaders sometimes can't handle the complexities of social-justice agendas."

**2.7.7.5 Boards do not make all operational decisions:** Some societies have a "hands-on" board that is consulted on most issues. In other organizations, boards may confine their role to deciding only the more important policy or financial issues that face the society, leaving the bulk of operational decisions to the society's officers or employees:<sup>16</sup>

Most corporate business does not come before the board and is not attended to by the board. The more complex the organization, the less likely that a board will become involved in a particular decision....

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13. DeMott, *supra*, n. 6, 140.

14. *Ibid.*, 145.

15. C. Howard, *supra* n. 4. Often, programs are run in such ways that there is not enough information for a board of directors, or for an outside funding body, to assess performance. Some common problems: inadequate "baseline" information (about conditions as they existed before the program began); inadequate stipulations about how the funds are to be used (e.g., no productivity targets); no performance measurement indicators; and no requirement that recipients of funds be accountable for the application of the funds: see, e.g., the discussion at para. 2.10.7-2.10.11 about licensed gambling and the conclusions of the Auditor General respecting the monitoring of some government programs. See further the discussion on service contracts beginning at para. 4.4.2.6.

16. James J. Fishman, "Standards of Conduct for Directors of Nonprofit Corporations," (1987) *Pace Law Rev.* 389, 395. See also J. Carver, *Boards That Make a Difference: A New Design for Leadership in Nonprofit and Public Organizations* (1990) 84; D. Kurtz, *Board Liability: Guide for Nonprofit Directors* (1988) 8 ("Directors are Monitors, not Managers"). Recent stories carried by the media bear out this perspective. See, e.g., J. Partridge, "Blind trust could have solved Jackman's woes," *Globe & Mail* Feb. 6, 1995 B3 ("...while boards of directors do such things as set policy, approve strategic plans and hire and fire chief executives, they're not involved in day-to-day management."); Editorial, "College's finances merit a closer look," *Vancouver Sun*, Feb. 14, 1995 A14 ("The picture that emerges is of a board that doesn't want to be bothered with details and, in effect, lets the president run the college without interference or much direction." See also W. Boei, "College funds misused, lack of control cited in report," *Vancouver Sun*, Feb. 19, 1995 A1.) One reason boards should leave operational matters to staff is that boards usually meet too infrequently to be able to assume responsibility for day-to-day administration of the agency. Another reason is that boards that do not leave operational decisions to staff become bogged down and unable to fulfil their duties with respect to setting broad policy directions: J. Por, "Effective Performance: Guidelines for Not-For-Profits," (1994) 12 *Philanth.* 3, 5.

A board, consequently, will not always become aware of conflicts issues, such as where a director enters into a transaction with the society that is “authorized” by a society employee.

**2.7.7.6 Not all board members feel personally responsible for board decisions:** many are prepared to accept the leadership of others and forgo accepting personal responsibility for decisions in which they ostensibly participate. This is particularly true for organizations with many directors,<sup>17</sup> and those that seek well-known “figurehead” directors to participate as board members in name only. “Figurehead” directors are much sought after by societies, not because of their directing ability but because of other, often more important, contributions they are capable of making. A society benefits, for example, from being associated with well-known and well-respected members of the community, who may be capable of raising the society's profile and prestige, and attracting members, sponsors and new and more generous sources of funds. But the “figurehead” director is a mixed blessing.<sup>18</sup>

Because nonprofits tend to have many directors who are on the board for “window dressing” only, a common phenomenon of nonprofit boards is directors who do not direct. The “figurehead” directors assume non-involved roles on the board, rarely attending meetings, and certainly never involving themselves in oversight responsibilities. They are corrosive to nonprofit corporations in that they allow employees or fellow directors to dominate the organization. Yet, such directors can be personally liable for losses resulting from nonmanagement and nonparticipation.

Members and employees of a society are seldom anxious to assume the responsibility of challenging board decisions.<sup>19</sup> They will usually feel they are entitled to rely upon the integrity of those elected to the board. Some board members, particularly “figurehead” directors, may be inclined to defer to the views of one or two particularly knowledgeable or active directors, overlooking that all board members share equal responsibility for the soundness and legality of board decisions.<sup>20</sup> In this atmosphere, the unfettered discretion a board currently enjoys allows transactions to be approved that would be rejected under an approach which clearly distinguished between acceptable and unacceptable conflicts of interest.<sup>21</sup>

#### 2.7.8 *Factors affecting a decision to allow the transaction to continue:*

**2.7.8.1** The board's responsibility to protect the society's interests does not end after a decision is made to authorize a transaction touched by a conflict of interest. Tough decisions must often be made in the course of the transaction. Sometimes, for example, it will make good sense to terminate a transaction. That may sometimes mean incurring liability for breach of contract but some transactions may be set aside with no cost to the society at all.<sup>22</sup> The board members who approved the transaction, however, may be reluctant to take the necessary steps for a number of reasons, such as the following:

**2.7.8.2 People feel a sense of complicity:** Participation in the decision to approve may, ironically, cause board members who originally felt uninvolved to later feel a sense of complicity. What initially seemed to be an irrelevant personal interest of a director when the transaction was first proposed and approved, for example, may later loom as more serious. Others seeing the matter only with hindsight are often unforgiving, as the press often seems to be with most political figures as well as crown and

17. Por, *ibid.* n. 16, 6. The larger the board, the more difficult becomes effective decision making.

18. Fishman, *supra* n. 16, 397.

19. This is a common reaction when people do not have a personal or financial stake in the matter. It is also common to find people who are unwilling to challenge decisions made by elected leaders (the directors) or who assume that other bodies, such as government, should look after matters.

20. Directors of the U.S. National Association for the Advancement of Coloured People (N.A.A.C.P.) did not challenge fiscal improprieties of the organization's chair of the board for a period of ten years until, apparently, they discovered “...that, as directors, they could be held personally liable for the organization's fiscal miscues:” J.E. White, “Scrap the N.A.A.C.P.” *Time*, Feb. 13, 1995, 39; J. E. White, “A Matter of Life and Death,” *Time* Feb. 27, 1995, 35. Some members will discount personal perceptions because they know, like and trust fellow directors. Expressions of public support for the good work of the society might reinforce belief in the propriety of board behaviour. Members might even assume that various other bodies have approved board actions. The process of auditing financial statements, or the continuation of funding or special privileges (such as gaming licenses or registered charity status) might all seem like assurances that business is being conducted soundly.

21. Fishman, *supra* n. 16, 413-4.

22. *E.g.*, where the interested director did not disclose fully, the court has such a jurisdiction under s. 29 of the *Society Act*.



nonprofit public service agencies. Merely taking part in the original decision to authorize the transaction may provide a reason to gloss over the original mistake.

**2.7.8.3 People want to protect their agency:** There is a natural fear--shared equally by everyone with a stake in the agency and its activities--that dealing with matters publicly (by alerting the media or a government agency, or by commencing court proceedings) may discredit the work of the agency (and, by extension, the whistleblower):<sup>23</sup>

They are especially loathe to go public, and with good reason. There are too many people out there looking for excuses to dismiss all social programs. As [...one person]...put it, talking about a recent case: "When that story broke, the whole focus was "Social-Housing Scam." But if it had been the private sector, the headline wouldn't have been 'Business Corrupt--Here's An Example!'"

People dedicated to the work of a nonprofit agency will often attempt to avoid unfair publicity by resolving problems internally. Problems that cannot be resolved in this way might be ignored.<sup>24</sup>

**2.7.8.4 Consensus orientation:** Nonprofit enterprises tend to attract people who are consensus-oriented. Such people are sometimes unprepared to take the necessary confrontational steps when an abuse arises:<sup>25</sup>

...people in the social-justice sector often expect life in their organizations to reflect the democratic ideals in which they believe--without knowing how to make that happen...

...many people who go into the not-for-profit sector are repelled by the way the private sector so openly prizes, and brandishes, power. Because they want only to avoid power struggles, they're ill prepared to mount a defence when abuse creeps in.

This, like many of the factors already mentioned, may affect director, member and employee alike.<sup>26</sup>

**2.7.8.5 People feel powerless to make a difference:** Even those who are prepared to act face difficulties. They may not have enough information to assess the situation properly and so proceed on mistaken assumptions.<sup>27</sup> A transaction, impeccable in the light of full information, may appear to be questionable when only a few isolated facts are known. Even where there is enough information to establish that decisions were made prejudicing the society, there may be no practical recourse: court proceedings are expensive,<sup>28</sup> and other avenues are uncertain (such as alerting media, a funding body, or government). Action may carry risks. An agency's funding, for example, may be placed in jeopardy without necessarily addressing the problem. The person's actions may threaten friendships, employment opportunities,<sup>29</sup> or reputation. Sometimes the best that can be hoped for is a stalemate. But this may

23. C. Howard, *supra* n. 4. A similar suggestion is made about positive reviews about french immersion programs: H. Hammerly, "Ecoutez! Most French immersion graduates are not bilingual. They're 'Frenghish' speakers. You're not being told that," *Vancouver Sun*, Jan. 3, 1995 A9. Follow up articles and letters disputed these assertions: "Speaking in Tongues," *Vancouver Sun*, January 9, 1995; W. Johnson, "French-immersion supporters up to their necks in critics," *Vancouver Sun*, Mar. 30, 1995 A12.

24. The more homogeneous the board or the makeup of the society, the more likely directors and members will protect each other. This will be particularly true where family relationships are involved. J. E. White, *supra* n. 19 at 39: "Former N.A.A.C.P. staff members...say the critics did not speak up sooner out of fear of 'washing our dirty laundry in public.' That's another way of saying they did not want the N.A.A.C.P. rank and file to know how badly its affairs were being handled."

25. C. Howard, *supra* n. 4.

26. Of course, not everyone is consensus-oriented and some involved in non-profit endeavours are exceedingly zealous in pursuing any perceived wrongdoing.

27. People involved with a society often have little more information than is available to the general public, and not enough to determine whether there is a problem. Even under freedom of information legislation, not all records are accessible. *See, e.g.*, Office of the Information and Privacy Commissioner, Province of British Columbia, Order No. 21-1994, August 15, 1994: *Inquiry re: A Decision to Withhold Records of the Ministry of Health and the Ministry Responsible for Seniors*. It was held that the public is not entitled under B.C.'s freedom of information legislation to have access to financial records of a nursing home financed by government. The applicant had been concerned about the level of care a patient was receiving.

28. The costs of the proceedings must be borne by the member. Litigation is expensive. Even someone having the public spirit to assume the burden in time and responsibility is unlikely to have or be willing to expend personal financial resources to launch legal proceedings.

29. Some jurisdictions have responded to this concern by enacting "whistle blower" protection legislation.

mean that the scarce resources available to the agency are squandered in internal dispute.<sup>30</sup> Matters are further complicated by the amorphous conflicts of interest standards that currently apply, under which basically any transaction, however dubious, becomes defensible solely on the basis that the board approved it.<sup>31</sup>

### 2.7.9 Summary

2.7.9.1 Many factors arising from the environment in which a nonprofit agency operates--even the procedure for authorizing conflicts itself--promote feelings of personal complicity or the desire to avoid warranted or unwarranted negative publicity, so that boards and agencies sometimes develop an insular collegiality that operates to shield inner management decisions from public scrutiny. Problems raised by these factors are aggravated by the current rules, which provide no guidance on identifying conflicts of interest nor on how to deal with them. Every one of the problems posed by these factors, however, is addressed by setting out clear conflicts of interest rules.

## 2.8 Practical Considerations for Opposing the Suggested Solution

2.8.1 Some correspondents predicted that the suggested changes would worsen, not improve, the law. The changes, they feared, had the potential to increase administrative expense and discourage volunteers, to the cost of important community activities and services. This section discusses the practical objections that were raised.

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30. Where the membership takes steps, and retains control of the process, there is sometimes an opportunity to achieve something, notwithstanding the disparity in power between board and membership. In a few well publicized cases, *e.g.*, a concerned membership has managed to produce a stalemate in the conduct of society affairs. But it is not clear that these events can be looked upon as unalloyed triumphs of member supervision of board decisions. *See, e.g.*, the events surrounding the Vancouver Museum and a union dispute involving layoffs in which the membership became actively involved in opposing board policies. Whatever the merits of the dispute, it appears to have posed significant financial consequences for the museum: F. Bula, "Tug of war over museum heats up," *Vancouver Sun*, Oct. 4, 1994 B1; A. Strachan, "Group claims extinction looms," *Vancouver Sun*, March 27, 1995 B1; "Museum trying to cut losses," *Vancouver Sun*, Feb. 3, 1995 B4; A. Strachan, "Museum's healing process has started, president says," *Vancouver Sun*, Apr. 17, 1995; F. Bula, "Museum gets \$636,000 operating grant," *Vancouver Sun*, May 19, 1995 B5.

31. We were told of a number of instances where the only recourse available to a board member who would not be a party to particular decisions was resignation. It is a step that protects the member, but not the society, which is left at the mercy of the other directors.

2.8.2 *Too Much Red Tape*

## 2.8.2.1 The CP suggested:

- revising the procedure for authorizing transactions affected by a conflict of interest and
- limiting the kinds of transactions that could be authorized.

An important point, that some might have overlooked, is that only a few transactions would be considered acceptable under the new rules. Some who opposed the changes appeared to have a different model in mind. They seemed to assume that all of the transactions now capable of being authorized would continue to be acceptable under the new law. On this view, the only consequence of legal change was to require boards to stamp approval in different, more complicated ways. Had this been intended, we agree that the changes would lead to much meaningless expense and activity, and not a little confusion, possibly convulsing small societies in, as one submission put it, “potentially devastating squabbles over trivial matters.” But it was not what was proposed.

2.8.2.2 The CP suggested that societies should, as a general rule, avoid any transaction in which a director has a conflict of interest. We remain of this view. If there is a conflict of interest, then a transaction not plainly in the best interests of the society should not proceed. Problems cannot arise unless some directors insist upon attempting to derive personal advantages from their positions of trust, and others allow them to do so.

2.8.2.3 We agree, of course, that rules aimed at serious conflicts of interests must not embroil societies in disputes over essentially trivial matters. Any conflicts rules, even the current ones, have that unfortunate potential, in theory but not in practice. Meaningless disputes tend not to occur because societies simply ignore inconsequential matters. There is no reason to believe that legal change will cause people to give up sensible practices.

2.8.2.4 Most legal principles look ridiculous when applied to petty issues. Suppose A agrees to buy a piece of gum from B for a nickel. A then decides not to complete the transaction. Theoretically A can be sued for breach of contract, but the gum vendor is unlikely to gear up court proceedings to deal with the issue. A gum vendor who did so would not receive a sympathetic hearing from the judge. The law is not concerned with trifles. Correspondents who raised these concerns have overreacted.

2.8.2.5 That is not to say that directors should feel free to ignore ethical standards when the amount of money involved is small. Many believe that it is important to be equally scrupulous about matters that are serious and those that are less consequential. A conflict of interest raising an ethical issue, however trivial, should usually be resolved by avoiding the conflict. Even so, “devastating squabbles,” if they arise at all, will arise only where the matter has importance because of the amount of money involved, or for symbolic reasons.

2.8.2.6 Is there any substance to the fears of some, such as those expressed in the following two submissions, about an increased administrative burden?

- Involving the smaller and essentially private societies would add the unnecessary burden of bureaucracy, administration and paperwork for what are largely volunteer organizations...
- All employees of such organizations must be adequately trained with respect to the eventual legislation and the guidelines. There is also a significant cost to the organization in the creation, implementation, and monitoring of the guidelines. This would not only include staff costs but in the case of larger organizations, independent legal advice and organizational consultants' advice might be required.

2.8.2.7 Nothing in the suggested legislation imposes a duty to monitor. Even by implication, nothing in the legislation requires any more monitoring than currently exists. Societies should already be concerned about conflicts of interest involving their directors and others involved in their activities.

2.8.2.8 The current law requires the board to authorize transactions in which a director has a conflict of interest. So will the new law. The CP suggestions provided a legislative statement of the kinds of principles that, we believe, should already be observed by boards. Even if our views on that point are incorrect, the only difference under the new law, from an administrative perspective, is that it will permit fewer classes of transactions to be authorized. That type of change cannot increase a board's administrative tasks. It should actually decrease them, because there should be fewer requests for approval.

2.8.2.9 It is also worth pointing out that one recommendation will streamline the approval procedure: instead of requiring a director to give notice to each director, only notice to the board will be required.<sup>32</sup>

2.8.2.10 We understand how the perceptions reflected in these comments could arise. It is a likely reaction to seeing a legislative statement of conflicts principles. These same principles currently exist. People simply tend to be unaware of them.

2.8.2.11 Those that foresaw major changes in the way they operate probably operate by routinely ignoring existing conflicts of interest. Many societies do. Rules that are ignored impose no administrative burden. But the rules should not be ignored. The current approach is flawed because it fails to make people aware of the conflicts issues.

### 2.8.3 *People Will Not Volunteer*

2.8.3.1 An argument against legal change frequently repeated in the submissions was that the new laws would discourage volunteers from participating in society work. Here is a sample of the comments on this point:

- ...In some areas of law, such as income tax, courts have imposed almost strict liability on directors of societies which are charitable organizations and this is not very sensible. Surely it is becoming hard enough to find high quality men and women willing to volunteer as directors without imposing such onerous obligations on them.
- Our projects which receive public funds are all only partly funded - we are required to put up either half or sometimes two thirds of the needed money. This means extremely careful budgeting and we are anxious that we are permitted to hire the most appropriate workers regardless of any affiliation.
- In summary, I compliment you on your scholarship. However, I disagree with your premise. I believe that the question of directors' conflict of interest in societies is properly dealt with in existing legislation. I am concerned that your draft legislation although legally sound is a remedy looking for a wrong. It is difficult enough to attract qualified persons to boards of societies. I would hope we don't muddy the waters more.
- These organizations often find it difficult as it is to persuade volunteers to serve on their boards. Furthermore, the proposed LRC legislation may disqualify or prevent from serving on the board some very valuable people. All societies and related organizations...have examples of current and past board members who have provided invaluable service, but who would either have been disqualified from serving or reluctant to offer to serve if the legislation as proposed were in place.
- We considered that these provisions would probably discourage lawyers, accountants and other professional persons from agreeing to become directors of many societies with the result that many societies would be deprived of desirable assistance.

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32. See s. 3(2)(a) of the draft legislation in Volume I.

- A possible limitation to conflict of interest legislation is the placing of community leaders at arms length from community organizations serving the public's interest. In our view, legislation that effects this outcome actually harms the public interest.

Our province's health care system is undergoing considerable strategic reforms. Non-governmental organizations are serving quasi-governmental roles, providing government services, and proliferating to serve a multitude of public interests. The availability of community leaders to provide strategic direction is essential to the public interest.

With respect to health charities, vision and clarity of direction are essential to adapting to present reforms of the health care system. At this pivotal time, the Foundation therefore cautions the Commission on the point of leadership.

- I believe that intelligent laymen should be encouraged to volunteer to serve their community as directors and officers of Societies. The fact is that most volunteer directors' understanding of the law is very limited. It follows that, as long as they act in good faith, there should be no risk to themselves personally arising from their efforts on behalf of a society. The apparent shift of onus proposed in the discussion paper will cause many perceptive volunteers to say, "Why bother?"

2.8.3.2 New rules might discourage some volunteers. The rules might increase the chances of a director becoming personally liable for making a mistake. But we took this into account. Protective measures for directors who act in good faith were recommended.

2.8.3.3 Many who wrote welcomed new rules. These people thought that a clear statement of conflicts principles would help them know what was permissible. New rules would also set a standard for dealing with those volunteer directors who were suspected of either bending the rules or applying limited resources in dubious ways. Because the current law allows basically anything to be authorized, it is sometimes difficult to control a strong director intent on self-dealing. People concerned about mismanaged resources often have only two choices: put up or resign. Neither course deals with the fundamental problem.

2.8.3.4 Some told us that the current rules already serve to ensure ethical behaviour by directors. We suspect this view must also have been implicit in the submissions of most of those who opposed changing the current law. If the current rules already ensure ethical behaviour, amending the rules to more precisely define the standards expected by the community can have no deleterious effect. The rules will simply describe what directors are doing.

2.8.3.5 The nonprofit sector is only minimally regulated and scarcely accountable to anyone. Public officials, on the other hand, are subject to the closest scrutiny and regulation. Everyone is appalled when public officials depart from the kinds of standards set out in the CP when handling public money. When the same money is placed in the hands of a society asked to achieve similar objectives, there is no legitimate argument to support the proposition that directors should not aspire to the same standards. It is simply not defensible to suggest that directors should be allowed to personally profit from these funds.

## 2.8.4 *People Will be Disqualified from Serving*

2.8.4.1 The change in rules will, naturally, affect some people who are currently in a conflict of interest position. They will have to make some difficult decisions about whether they wish to continue their involvement with the society and in what capacity. Some people thought this was a reason for not changing the law. The argument is difficult to follow. Where it is decided that certain kinds of conflicts of interest should be avoided or not allowed at all, no policy is served by protecting long standing

relationships raising those conflicts. Moreover, rules that require a director to resign will not prevent the director from continuing as an active, and helpful, member.<sup>33</sup>

2.8.4.2 What is to be done if there are not enough people free of conflicts to assemble a functioning board? While it is desirable to adhere to a rule that prohibits any conflicting interests, what choice should be made if the only options are (a) tolerating a conflict, or (b) not having the good work of the society carried out?

2.8.4.3 The legislation recommended in Volume I of this Report has been developed with this issue in mind. An absence of volunteers is viewed as a pragmatic factor that can, in some cases, override the policy to exclude conflicts of interest. But the presence of this factor would not be established by simply saying, “well, no one else showed up.” Moreover, two options exist for enterprises unable to attract volunteers. The enterprise may be successful in an application to exempt the society from the operation of the legislation.<sup>34</sup> Or, if there is no support for a society, the body could be incorporated as a company or, where appropriate, a cooperative association.

## 2.8.5 *Too Complicated*

2.8.5.1 The current law has so deceptively simple an appearance that many organizations are oblivious to the issue of what is a conflict of interest. The CP suggestions, which attempted to set out meaningful guidelines, were seen by some as being unacceptable because they were too complicated. We suspect the problem here is that some people regard precision and detail as synonymous with complexity. What is often overlooked is that general statements of principle, notwithstanding the appearance of simplicity, tend to be more difficult and uncertain to observe or apply than precisely stated rules.

2.8.5.2 Most of the correspondents who complained of complexity also opposed the general policy objectives identified in the CP. For example:

...it is [our] position that proposed legislation requires simplification. The terms used to define conflict of interest and application of the proposed model guidelines are very broad as to their intent...The Consultation Paper lacks clarity as to what practical changes in addressing conflict of interest are to be effected by the Standards of Conduct Act and Conduct Guidelines.

Even some who agreed with the objects of reform were dismayed by the level of detail needed to achieve them:

- I think the general thrust of the paper is good, but it is important not to make it too complex, or it will not be adhered to.
- ...greater regulation and the potential for liability for a violation which they were not party to, may limit the desire of [professionals] to act as a director or to volunteer their time. As a result, we recommend that the regulations be kept simple so that they may be easily followed.

The decision recorded in Volume I of this Report that the conflicts rules for directors should be set out in Director Transaction Rules scheduled to legislation goes some distance toward meeting these concerns. Even so, these criticisms overlook the extent to which clearer rules will benefit the board and individual directors. By setting out the boundaries, the rules make it easier for all to fulfil their respective duties. It is also worth observing that professionals need not be directors in order to volunteer their professional services.

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33. One particular relationship placed in jeopardy by the suggested legislation raised a great deal of concern among correspondents. This was the arrangement where an organization's chief executive officer is also a member of the board of directors. The discussion of this issue begins at para 3.9.

34. See s. 11(2) of the draft legislation in Volume I.

## 2.9 Alternatives

### 2.9.1 Overview

2.9.1.1 Some correspondents accepted that problems with the current model existed. But, they argued, these problems can be dealt with by adding new disclosure standards to the *Society Act*. This section also discusses two other approaches that have received support but which were not raised by our correspondents: increasing penalties for directors who self-deal; and requiring funding bodies to assume increased responsibility for monitoring agencies they support.

### 2.9.2 Disclosure

2.9.2.1 Some submissions suggested that the current model, if combined with increased disclosure requirements, would be an effective method of safeguarding against conflicts of interest. Disclosure would serve three groups in monitoring the activities of the board: society members, contributors and the public:

- Our short comment is to suggest that a clear statement in the audit report of the directors or auditor should spell out any conflicts or potential conflicts in any of the director's dealings with the Society.

The information would then be available to the members at the annual meetings and to the public when filed with Victoria.

There could be penalties imposed by the act for the failure to make the disclosure and further for failing to file the reports.

This would perhaps relieve the suggestions that there be some exceptions to the rule which, of course, will court exception to the exceptions etc. and once again, create abrasion by the mockery.

The printed form of the annual report of the societies being currently set out could be amended to have the question whether or not any conflicts existed for the current year.

- I also have problems with a proposed law which (a) not only seems not to really address the problem but (b) tries to handle things by universal application of a rule that may not apply universally.

In general I am much more in favour of a system that does not try to directly control every possible situation but rather makes the information public that is necessary for those concerned to determine if an abuse has occurred and let the opprobrium of society provide the control.

For example, require every society, society director and senior manager file a disclosure report (not unlike those filed by municipal officials) that lists all dealings between non-arms-length entities (such as directors, senior staff members, major contributors, and immediate family members of same) and the society (financial as well as "in kind"). Make failure to file a complete or timely report an offense.

Then those people who contribute to a society (or the public funding bodies) can review the report and determine if they still wish their money to be used to support the activities described.

The idea is not to try to determine in advance and universally what transactions shall be permitted, but rather let the cold harsh light of public scrutiny keep the other board members on their toes. The potential for embarrassment (both of the board and the public bodies that fund the society) will go a lot further...in keeping them in line than a law which merely forbids dealings with full board members.

- It is important to note that while guidelines for individuals are in place, emphasis is placed on removing conflict of interest from the process. A fair process best protects and controls any individual bias. In this regard, openness and disclosure are an effective response to conflicts of interest.

These extracts provide a good description of how a public disclosure requirement might operate, and of some advantages that might flow from adopting it. Public disclosure, however, has not proved to be

effective in other arenas.<sup>35</sup> It is often an intrusive approach which carries with it an administrative burden. Nor does it address what we see as the fundamental problem in transactions that involve societies: the misconceived tolerance for director self-dealing.

2.9.2.2 One submission suggested that the “potential for embarrassment” will keep a board in line. This seems to presuppose that board members are currently making decisions they know to be wrong, but make them because no one is watching. The information we received during consultation indicates that boards that authorize a conflict of interest usually believe the decision to be sound and ethical. These boards tend not to see anything amiss in director self-dealing. We heard from many people holding that view. We suspect that the board of the Victoria Commonwealth Games Society was surprised to find any public opposition to the idea of allowing directors to enter into business relationships with the society.

2.9.2.3 The suggestions about the financial audit process might not be well received by auditors. Modern audits test the soundness of accounting systems. It is not currently the responsibility of an auditor to check for conflicts of interest.

2.9.2.4 The answer, at least in part, is to educate boards that some transactions, apparently sensible from a business viewpoint, are unacceptable uses for public funds. The focus of reform must be on providing a board with the necessary information, structure, and inducements for rigorously assessing and monitoring transactions.<sup>36</sup>

2.9.2.5 While we have concluded that a public disclosure model should not be adopted, one aspect of the current disclosure requirements placed on directors should be amended. The law requires a director who is in a conflict to notify every other board member. As described in Volume I, this obligation may be inconvenient, or impossible, to discharge. The law should be changed to require written disclosure to the board.<sup>37</sup>

### 2.9.3 *Increased Penalties*

2.9.3.1 It has been suggested that the current conflicts model can be made to work by making more severe the consequences to a director of breaching duties owed the society.<sup>38</sup>

...a revision of the substantive fiduciary standards would not bring about greater compliance because it fails to address the problem of actual enforcement. Similarly, an expansion of existing standing rules, although addressing the underenforcement problem, would not ensure greater compliance because it opens the door to potentially frivolous suits and does not encourage a significant increase in claims...[T]he most desirable option is an increase in the liability of directors who knowingly breach their duties...[through] the adoption of a system of fines for duty of loyalty violations.

Similarly, the range of remedies available to the society and its members can be broadened.<sup>39</sup>

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35. The experience in other jurisdictions (as well as local experience with disclosure models in other areas of the law, such as insider trading and the Vancouver Stock Exchange) shows that a disclosure model is costly, contributes substantially to the administrative burden of agencies subject to such requirements, and often ignored: *see, e.g.*, Editorial, “Cull should ignore VSE complainers,” *Vancouver Sun*, Mar. 9, 1995 A16, which points to evidence that securities laws concerning public disclosure requirements continue to be routinely flouted.

36. This approach also helps interested outsiders. It provides them with a standard against which to measure the conduct of a society, its board and its directors. One of the advantages of adopting zero tolerance for self-dealing, pointed out by others, is the ease of policing the approach. Any breach of fiduciary duty becomes easy to detect: “Developments in the Law--Nonprofit Corporations,” (1992) 105 Harv. L. Rev. 1578, 1603-4; Henry B. Hansmann, “Reforming Nonprofit Corporation Law,” (1981) 129 U. Pa. L. Rev. 497. But similar benefits can be expected from any system that provides better tools for determining whether or not a transaction is acceptable.

37. *See* s. 3(2)(a) of the draft legislation in Volume I of this Report.

38. “Developments in the Law--Nonprofit Corporations,” *supra* n. 36, 1601.

39. Such as by adding the power to remove a director: *see, e.g.*, “Former watchdog regrets inaction,” *Vancouver Sun*, Dec. 1, 1994 A2 (M. Mackenzie, a former federal regulator of financial institutions, told the Senate Banking, Trade and Commerce Committee that the collapse of Confederation Life Insurance Co. might have been better handled if regulators had the power to remove directors. The Senate Committee recommended giving regulators broader powers in this respect: Report of the Standing Senate Committee on Banking, Trade and Commerce, *Regulation and Consumer Protection in the Federally-Regulated Financial Services Industry: Striking a Balance* (November, 1994).



2.9.3.2 Increasing penalties is a step that might improve the current law, but it too fails to address the central concern. The B.C. conflicts model allows boards to authorize transactions that involve a conflict. Once properly authorized, no legal wrong has occurred. The approval process is defective because many are unaware of what constitutes a conflict of interest, and there is a wide range of views about where to draw the line between beneficial self-dealing by a director and unacceptable self-dealing. This problem can only be resolved by adopting clearly defined rules. Once these conflicts rules are in place, consideration can be given to changing the penalty structure. The Commission does not recommend this course of action at the present time.<sup>40</sup>

2.9.3.3 The current approval process does not work because boards do not have a handy reference. Boards need a structure for resolving conflicts issues.

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<sup>40</sup> The step may be unnecessary in any event because directors, as fiduciaries, are subject to very severe penalties for breaching duties. To the extent the revised conflicts model would define director's duties with greater precision, the remedies already available for breach of fiduciary duties would become easier to apply.

## 2.10 *The Role of Funding Bodies*

2.10.1 Often, when the media notes instances of public money apparently being applied inappropriately, the suggestion will be made that had the body (usually government) that funded the agency paid closer attention, these abuses could have been prevented. The *Annual Report* of British Columbia's Auditor General makes such a suggestion in connection with money raised through licensed gaming.<sup>41</sup> How well placed are donors of funds to supervise agencies they support?

2.10.2 The following discussion is illustrative, not comprehensive. It considers the ability of third parties to supervise how societies apply funds that:

- are donated by individual contributors
- are made available by government
- are raised through gaming
- allow the donor a tax deduction

2.10.3 **Individual Contributors:** The records for registered charities show that 11 per cent of their revenue is derived from donations made by individuals.<sup>42</sup> These donors are not well placed to insist that organizations they support adopt particular standards of conduct, nor supervise how well these organizations meet the standards they purport to adopt.

2.10.4 Even so, organizations wishing to maintain the good will and support of individual donors are well advised to maintain a good public profile. An organization that receives unfavourable publicity will find its donations suffer. Donations made to other, unrelated charities, may be similarly affected.<sup>43</sup> The accusations that senior employees of the United Way mishandled sizeable amounts of money, for example, had this kind of blanket result:<sup>44</sup>

...As of mid-March, results from the 1992-93 United Way campaign were down 3.3 per cent from 1991-92 levels, despite continuing demand for the social welfare services provided by organizations funded by the United Way. Although competing charitable providers reportedly view the United Way's plight as an opportunity, another possible consequence would be fewer donations overall to the United Way and comparable organizations....

2.10.5 **Public Funds Made Available By Government:** government has available a variety of methods for supporting nonprofit agencies.<sup>45</sup> It may make direct<sup>46</sup> or indirect grants,<sup>47</sup> or enter into

41. Auditor General, 1994/95: Report 3, *Report on the 1993/94 Public Accounts, Province of British Columbia*. It is probably true that in most cases a person concerned about the activities of a society may find the most prudent course is to write and advise funding bodies about these concerns. Few funding bodies wished to be involved with controversy and will usually take such suggestions seriously. A current issue under freedom of information legislation is whether the name of a person who makes false accusations can be revealed. The Information and Privacy Commissioner, David Flaherty, has ruled that this information must be disclosed in the case of a complaint made to the B.C. Ministry of Environment about a recycling program: Order #36--1995 (March 31, 1995); see also "Victoria ordered to identify person making false accusation," *Vancouver Sun*, April 6, B8. It has been suggested that funding bodies should have status to sue to enforce the observance of fiduciary duties: DeMott, *supra* n. 6, 144.

42. M. Connell, "How will Canada pay for its charities?" *Globe and Mail*, November 29, 1994 A21.

43. The effects of negative publicity may be short lived: "Canadians donating more as governments cutting back on aid," *Vancouver Sun*, Jan. 6, 1995 A6. P. Fong, "Still Counting," *Vancouver Sun*, Jan. 5, 1995 B1 reports that the United Way is closing in on its 1994 campaign goal, but possibly the 1994 goals were adjusted to reflect reduced expectations. Or perhaps funding levels have been restored as a result of the public process by which the senior members found at fault were punished, repairing confidence in the charity. Donations made to all Canadian charities in 1994 were down about 25 per cent from 1993: P. McMartin, "Christmas donations terrible," *Vancouver Sun*, Dec. 13, 1994 B1. CP, "Charities to make pitch to maintain tax credit" *Vancouver Sun*, Dec. 9, 1994 E4. The downturn may be attributable to general economic factors. Another suggestion is that it is a negative reaction to the aggressive campaign approach adopted by professional fundraisers over the past 10 years who, through computer-assisted telemarketing and letter writing, blanket possible donors many times over: A. Wright, "Under siege by charities," *Globe and Mail*, Dec. 13, 1994. The author advises that in the past year he and his wife have received 160 letters from 80 different charities. He suggests that this approach is self-defeating because it alienates donors.

44. DeMott, *supra* n. 6, 134. Glaser, J. *The United Way Scandal: An Insider's Account of What Went Wrong and Why* (1994). See also AP, "Ex-charity chief 'stole \$1 million' for lavish life," *Vancouver Sun*, Mar. 7, 1995 A10. The suggestion that possible fraud in the application of UNICEF funds in Kenya might affect fund raising was dismissed by the deputy executive director who said that, to the contrary, supporters are likely to be pleased to see the organization's swift response in investigating the allegations: Heil, "UNICEF uncovers possible 'fraud' in Kenya, suspends 7," *Vancouver Sun*, Jan. 11, 1995 A1.

45. The variety of methods means that it will not always be apparent that public funds have been invested in a nonprofit enterprise: see, e.g., J. Lamb, "Success of private enterprise is giving our MLAs that old sinking feeling," *Vancouver Sun*, Jan. 30, 1995 A3. The gist of the article is that the Artificial Reef Association of B.C. has, without government assistance, enhanced local tourism by sinking the HMCS Chaudiere off of Sechart, B.C. to create an artificial reef for a diving site: "New businesses and new jobs have sprung up to the tune of nearly \$1 million annually, all of it created without government help." But government assistance can be

(continued...)

service contracts. It may transfer property at less than fair market value<sup>48</sup> or allow the agency to use public property at a nominal charge. It may grant special privileges, licenses or concessions.<sup>49</sup> Three of these methods, direct grants, licensed gambling and tax concessions are discussed in the following paragraphs. The issues raised in these spheres are representative. They provide good examples of the problems facing any government that assumes responsibility for supervising how societies apply public funds.

2.10.6 **Grants:** The CP provided some details on provincial government grants made in the 1990/91 budget year. Money paid to 1100 B.C. societies totalled more than \$2 billion. The largest grants were made to societies that operate hospitals. Federal and provincial grants take many forms.<sup>50</sup> All levels of government are finding it increasingly difficult to fund nonprofit agencies. As a result, some of these agencies have turned to other forms of fundraising, such as selling more services and goods connected with their enterprises, and campaigning for more private donations.<sup>51</sup>

2.10.7 **Licensed gambling:** Gambling is a particularly lucrative form of fund raising. Gambling--in the form, for example, of bingo games, lotteries or casino nights--is only permissible with a government license.<sup>52</sup> Terms and conditions are attached to these licenses.<sup>53</sup> Two typical requirements are that people in the organisation serve as unpaid volunteers and that money raised in a community be used for charitable purposes in that community. Reviewing applications to determine their merit, and assessing how money raised through gambling is applied, is a vast undertaking.<sup>54</sup>

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45. (...continued)

found, e.g., in the terms by which the HMCS Chaudiere was acquired from government at a cost of \$1. Arrangements surrounding the scuttling of the HMCS Mackenzie as a diving site off Sidney, B.C., show the extent to which direct and indirect public support is involved in this kind of undertaking. The ship was acquired from government at a cost of \$200,000. \$160,000 of this was financed by loan to the society provided by the Western Economic Diversification Fund. The provincial government, through a B.C. 21 grant, contributed more than \$100,000 to promote recreational diving. In addition, funds were made available through an unemployment insurance job creation program to hire 10 people to salvage and sell material from the ship. In all, combined federal and provincial support for the venture amounted to \$585,000 in loans, grants, marketing programs and job creation: J. Lee, "Warships provide divers with world-class naval gazing," *Vancouver Sun*, Jan. 31, 1995 A1; J. Lee, "It was his first ship, but he's happy it's going to be sunk," *Vancouver Sun*, Feb. 2, 1995 B12.

46. Grants may also be tied to other fund raising performance. E.g., the federal government funds some organizations by matching contributions they receive from other sources: "The Rules of the Game," *Globe and Mail*, April 1, 1995 D5.

47. By which we mean grants not made to the society to carry out its objects, but grants made for some collateral purpose. Some examples of indirect grants include Canada Employment Council work opportunity grants and unemployment insurance grants to hire people who are receiving U.I.C. benefits.

48. The *Municipal Amendment Act, 1994*, S.B.C. 1994, c. 53, e.g., added s. 536.1 to the *Municipal Act*, R.S.B.C. 1979, c. 290, to provide that a municipal council can sell or lease:

...the interest of the municipality in real property to a non-profit corporation at less than market value if private gain is absent from the purpose for which the property is to be used.

The public must be consulted on transfers of this nature (by being given notice and an opportunity to comment).

49. E.g., the municipality may give a builder who is restoring a heritage building exemptions from zoning (referred to as "bonusing") which would increase the commercial advantages of developing a particular site. The Art's Club and Theatresports, in negotiations to purchase the Stanley Theatre, e.g., requested the City grant "air rights" to an additional 44,000 square feet that they could sell to other developers: F. Bula, "Stanley Theatre's hopeful buyers set stage to end 'private sale' rumor," *Vancouver Sun*, Jan. 19, 1995 A2.

50. E.g., Unemployment Assistance Job Development Program and reimbursement of tuition for attending a qualified training school; Canadian International Development Agency grants; Canadian Mortgage and Housing subsidies to provide affordable housing, or grants for residential rehabilitation; B.C. 21 grants; the infrastructure program; Social Sciences and Humanities Research Council; Medical Research Council; National Sciences and Engineering Research Council.

51. See, e.g., "Why We Market," UBC Alumni Chronicle, Spring 1995 23; D. Fischer, "Most women 'don't identify' with group," *Vancouver Sun*, Feb. 10, 1995 A4; D. Ward, "Charities want chunk of \$1-million inheritance," *Vancouver Sun*, Mar. 20, 1995 A3, (describing steps taken by charities to encourage people to consider "planned giving," by making testamentary and *inter vivos* bequests, targeting the massive amount of money that will be transferred over the next decade or so from the depression/World War II generation to the baby boomers).

52. Gambling is more lucrative than other forms of fund-raising, such as bake sales, or soliciting subscriptions: L. Bates, "We haven't got that giving feeling--but there may be a reason why," *Vancouver Sun*, Feb. 11, 1995 A16. In 1994, B.C. charities raised \$116.7 million through gambling. Most B.C. hospitals depend upon gambling for between a quarter to a half of their revenue: D. Bramham, "Lottery tax a loser, charities say," *Vancouver Sun*, Feb. 3, 1995 A1. Steps to allow private gambling pose a threat to non-profit agencies that rely upon this form of revenue. They may see a permanent decline of as much as 10 - 12 per cent in revenue: P. Nagle, "Charities losers as gambling goes private," *Vancouver Sun*, Feb. 11, 1995 A13. In B.C., crown agencies under two different ministries have responsibility for licensing particular forms of gambling: the B.C. Gaming Commission, under the Ministry of Government Services; and the Lottery Corporation, under the Minister of Finance and Corporate Relations.

53. See the *Terms and Conditions of License*, issued by the B.C. Gaming Commission, effective Aug. 1992, and the B.C. Gaming Commission Policy Manual, 1.1 (re eligible organizations).

54. The Gaming Commission is charged with regulating a rapidly growing industry. Government policy development in this regard has possibly lagged behind the growth of the industry. The Gaming Commission itself has noted difficulties in enforcing compliance. Problems of accountability, monitoring and inspection leave open some avenues for fraud.

2.10.8 George Morfitt, FCA, the Auditor General for British Columbia, reviewed aspects of (a) public funding of non-government organizations and (b) licensed gambling. The purpose of the review was to assess the procedures government ministries use to determine whether organizations are eligible for funding and whether funding is used as intended.<sup>55</sup> The Auditor General concluded that government was not receiving enough information to answer these questions for either grant programs or licensed gaming and that the monitoring of spending was generally inadequate. With respect to the now cancelled Community Grants Licensee Program (CGL), which placed funds raised through lottery tickets in the hands of societies, the Auditor General said:<sup>56</sup>

The success of any grants program operating in an environment where funds are scarce and demand is high depends on sound eligibility criteria for applicants and controls for monitoring the use of public funds. It is through the eligibility criteria that the government ensures that only eligible organizations that have a demonstrated need receive public funds. And it is through monitoring procedures that the government ensures that public funds are spent only on approved purposes within the community....

We believe that it is important to note that many worthwhile purposes may have been served by the program. However, we concluded overall that although the organizations funded may have been broadly defined as "charitable," the charitable purposes for which the funding were requested was often not adequately assessed and the organizations were not funded according to their financial needs. Furthermore, we concluded that the government did not adequately monitor the expenditures made by the organizations to determine whether the funds were actually spent in the community for the purposes approved.

2.10.9 The Auditor General's conclusions suggest that monitoring is very difficult. What is true for the provincial government is probably also true at the municipal and federal levels. Adding to government's responsibilities by requiring it to ensure both that funds are spent in the community for approved purposes, and that the transactions in which they are used are free of conflicts of interest is unlikely to provide a complete answer to the problems addressed in this project.

2.10.10 Part of the problem is that indicia that money has been misapplied, such as incomplete, informal or non-standard accounting records that purport to detail the application of funds are equally consistent with the actions of overworked, non-professional volunteers of the kind who typically apply for grants and gaming licenses. It would certainly be an overreaction to assume immediately upon receipt that defects in accounting records conceal wrongdoing. Distinguishing between defective records that conceal misapplied funds, and those that reflect the hasty but well-meant work of untrained volunteers doing their best, is not an easy task.

2.10.11 Another problem is that in the normal environment of many nonprofit agencies, which consists of too much work being done by too few people, there is a tendency to apply funds in informal ways. Someone may finance society activities out of personal resources, for example, awaiting reimbursement from the next fundraising drive. Informality makes it difficult to keep accurate records. Formal accounting requirements must often be bent to describe, even approximately, how money is spent, even in those situations where anyone fully aware of all the circumstances would agree that no wrong, indeed much good, had been done.

2.10.12 **Tax Concessions:** Nonprofit organizations that are registered as charities enjoy two valuable privileges.<sup>57</sup> They are exempt from tax within their authorized nonprofit activities, and they may

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55. *Supra* n. 41, 85, 100.

56. *Ibid.*, 100. As to government initiatives to increase accountability, see the joint Report of the Auditor General of B.C. and the Deputy Minister's Council, *Enhancing Accountability for Performance in the British Columbia Public Sector* (1995). Part II of this initiative will deal with developing an accountability framework for the relationship between government and funded bodies.

57. Tax exemptions and concessions are available at the federal, provincial and municipal level. The ability to issue a tax receipt is thought to be an important incentive for fundraising. Experience suggests that it is difficult to raise money in Canada if a tax receipt cannot be given: M. Philp, "Funding crisis threatening NAC's work," *Globe and Mail*, January 31, 1995 A4. At the municipal level, exemptions from property taxes are regarded as important forms of public support: e.g., *Salmon Arm (District) v. Salmon Arm Golf Club*, (1994) 50 A.C.W.S. (3d) 1124 (B.C.S.C.); *Carmelite Nuns of Western Canada v. Alberta (Assessment Appeal Board)*, (1994) 49 A.C.W.S. (3d) 440 (Alta Q.B.); *Partage Inc. v. Quebec (Communaute Urbaine)*, (1994) 49 A.C.W.S. (3d) 539 (S.C.C.); *Conseil de la Sante et des Service Sociaux de la Region de Montreal Metropolitain v. Montreal (Ville)*, (1994) 49 A.C.W.S. (3d) 540 (S.C.C.).

issue tax receipts for donations.<sup>58</sup> In 1993, 69,244 registered charities in Canada were authorized to issue receipts for donations they received.<sup>59</sup>

2.10.13 A tax receipt allows a donor to make a deduction from income tax otherwise payable. The favourable tax treatment of donations encourages donations.<sup>60</sup> It also makes government a funder of activities selected by the donor. The amount of money involved is sizeable. Personal donations to Canadian charities in 1993 totalled \$8.2 billion.<sup>61</sup> These donations supported claims for personal tax credits of \$3.2 billion, and resulted in a cost to government of \$800 million of tax foregone.<sup>62</sup>

2.10.14 The *Income Tax Act* sets out rules that an agency must follow to keep its registration as a charity in good standing and retain these privileges. The rules prohibit self-dealing and require a balance on the board of the agency to ensure that at least 50 per cent of the directors are dealing at arms length.<sup>63</sup> Charities are also required to file an annual report describing programs and providing details about how money was applied in that year.<sup>64</sup>

2.10.15 A charity can lose its registration if it uses donations for non-charitable purposes.<sup>65</sup> A common problem is an organization that uses part of its funds to promote the change of laws or of public attitudes. Registration will be revoked if the charity spends more than 10 per cent of its funds in such special interest advocacy.<sup>66</sup>

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58. Even non-charitable nonprofit organizations enjoy some tax concessions, as explained in "Rules of the Game," *supra*, n. 46, an article about tax benefits available to any special interest advocacy group:

It can deduct the expenses of its government-relations department. It can deduct the fees it pays to a lobbying firm. It can deduct the membership fees it pays to an association that lobbies on its behalf, such as the Business Council on National Issues. Businesses are also free, of course, to deduct some entertainment costs they pay for wine and dining politicians and policy makers.

59. "Rules of the Game," *ibid.* referring to information obtained from the Canadian Centre for Philanthropy.

60. A tax payer may claim a deduction for donations made to registered charities. The maximum benefit is generated for donations above \$200. A taxpayer may claim deductions for charitable donations totalling up to 20 per cent of net income. Gifts to the crown or a crown agent, or cultural gifts (under the *Cultural Property Export and Import Act*, R.S.C. 1985, c. C-51), have no limit, and may be deducted for up to 100 per cent of net income: S. P. Neely, "Recent Developments in Crown Agency Foundations," (1994) 12 *Philanth.* 31, 32:

Agents of Her Majesty in right of a province traditionally have been provincial galleries, museums and public archives. With the advent of new legislation in many provinces, new foundations for universities, colleges and other educational institutions, hospitals and museums have been created. These foundations are designated agents of the Crown in right of the province and accordingly allow donors to the foundation to claim a tax credit against up to 100 per cent of their incomes.

Under this legislation, e.g., a Toronto-based company known internationally for its animation work donated a collection of cels (animation art work on plastic acetate) valued at \$6.5 million, producing an income tax benefit of \$2.4 million: H. Enchin, "Donation wins Nelvana tax break, boosts profit," *Globe and Mail*, Apr. 19, 1995 B4. A publication called the *Equity Club Network* (1995) referred to the donations for cultural gifts as "Underground tax loopholes that are legal." There is some fear that abuses of the system may end the exemption. An example of a practice that might jeopardize the continuation of this policy is purchasing an artist's inventory at a discount and then donating it to a museum at an inflated value: Montreal Gazette, "Rash of dubious donations puts art tax-dodge in peril," *Vancouver Sun*, Mar. 25, 1995 B3; P. Wilson, "Tax scam won't be written off any more," *Vancouver Sun*, May 16, 1995 C4.

61. "Rules of the Game," *supra* n. 46. "Canadians donating more as governments cutting back on aid," *Vancouver Sun*, Jan. 6, 1995 A6.

62. M. Connell, *supra* n. 42. Not everyone claims the deduction. Had all allowable tax credits for the \$8.2 billion been claimed, the cost to federal government would have been more than double: R. Matas, "Charitable donations begin at home and end up heaven knows where," *Globe and Mail*, Oct. 22, 1994 D1-2. Statistics for B.C. show that in 1993 charitable donations were claimed on 25 per cent of tax returns filed. The median donation was \$150: L. Bates, *supra* n. 52.

63. See, e.g., s. 149.1 and the definitions of "charitable foundation", "charitable organization", "non-qualified investment", "public foundation" and "private foundation" (the *Income Tax Act* rules respecting arms-length dealing apply to all charitable foundations and organizations with the exception of private foundations). The approach in the U.S. is similar. Legislation prohibits "net earnings" of an exempt organization from being used to benefit shareholders or individuals involved with the charity, which has been interpreted as prohibiting self-dealing by directors of tax-exempt corporations: "Developments in the Law--Nonprofit Corporations," *supra* n. 36, 1598.

64. R. Matas, *supra* n. 62.

65. See, e.g., K. Bolan, "Anti-abortion group seeking donations in court fight over tax status," *Vancouver Sun*, Nov. 29, 1994 B2; R. Matas, "A taxing problem for Revenue Canada," *Globe and Mail*, December 2, 1994 A11. These articles discuss the position of an organization called Human Life International (HLI) whose objectives include preventing the practice of abortion. HLI is appealing a decision by Revenue Canada to revoke its charitable status made when the group's work became more political than charitable. HLI published literature on planned parenthood and many other controversial issues, such as sex education in schools, homosexuality, pornography, universal day care, contraception and sterilization. See also, D. Todd, "Persistent taxman draws ire of pastor," *Vancouver Sun*, Jan. 6, 1995 B1; D. Todd, "Church pastor-activist says tax probe was a witchhunt," *Vancouver Sun*, Dec. 24, 1994 A8, concerning a tax audit on a church located in Surrey, B.C. called the Bible Fellowship Church. H. Munro, "Church risks seeing tax-free status go up in holy smoke," *Vancouver Sun*, Mar. 7, 1995 B1.

66. R. Matas, *supra* n. 62; P. Mitchell, "The Political Purposes Doctrine in Canadian Charities Law," (1995) 12 *Philanth.* 3. See also the definition of charitable purpose in the *Income Tax Act*, s. 149.1(6.1). An organization, however, might spend 90 per cent of its revenue on salaries and 10 per cent on political activities and still retain its charitable status: "The Rules of the Game," *supra* n. 46.

2.10.16 Revenue Canada has only two tools for determining whether a nonprofit organization strays from its charitable objectives: reviewing the annual reports filed by the charity; and carrying out spot audits.

2.10.17 Neither tool is very effective. Annual reports seldom provide much information. Audits are expensive and Revenue Canada's investigative resources are limited.<sup>67</sup> Even where the misapplication of funds is detected, the penalty is not suffered by directors. It is the organization that loses its privileges.<sup>68</sup>

2.10.18 Monitoring by tax authorities is necessary, but cannot represent a satisfactory answer to conflict of interest problems.<sup>69</sup>

## 2.11 Relationship Between Government and the Nonprofit Sector

2.11.1 No one questions the responsibility of government to ensure that public funds are applied sensibly. Government must be convinced that the objectives of funded organizations are worthwhile. But there are problems in discharging this responsibility. First, of course, it must be recognized that monitoring is expensive and there are usually few benchmarks by which to assess how well funds are applied. But an even more important factor must be acknowledged: the model by which services are delivered by a nonprofit agency is premised on the idea of maintaining a separation between the agency and government. Closer relationships between nonprofit agencies and government tend to

- politicize the activities of the agency because government becomes more accountable for decisions made by the agency,
- involve government in making some kinds of value judgments that it is not well-placed to assess and
- diminish the economic advantages that exist from having nonprofit agencies deliver services and programs rather than government delivering the same kinds of services.

Overall the community benefits from placing a distance between non-profit organizations and government.<sup>70</sup>

...many nonprofits by definition support activity that is too idiosyncratic or controversial to attract funding from either for-profit or governmental sources. A blanket requirement of administrative approval creates the risk that the agency will subject transactions to especially close scrutiny when the nonprofit supports unpopular activities.

2.11.2 Nonprofit agencies are currently free to make decisions government cannot. For example, a nonprofit agency might conclude that teenagers require information about various health-related matters and distribute materials on sex-education that include information about AIDS. While relatively straightforward for a nonprofit agency to carry out, this kind of task has sometimes proved

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67. An audit will usually not be carried out unless Revenue Canada receives a complaint about a registered charity. A decision to revoke registration may not end the matter. In many cases the agency will appeal the decision and costly litigation will ensue. In the case of HLI, the audit was carried out as a result of a request by a former New Democrat MP after a conference held by HLI appeared to be more political than charitable: K. Bolan, *supra* n. 65. In 1994, Revenue Canada completed 665 audits, which disclosed in 128 cases that charities were in serious breach of the Act. 392 charities were advised by Revenue Canada of minor infractions: M. Philp, "Tax laws regulating charities permit loose interpretation," *Globe and Mail*, June 1, 1995 A6.

68. This part of the tax system operates largely on the honour system. The charity is trusted to issue receipts that reflect the actual value of the donation. The charity is also trusted to apply donations appropriately. There are few formal checks on how the money is raised or applied by registered charities: R. Matas, *supra* n. 62.

69. DeMott, *supra* n. 6, 139. It may also be questioned whether the skills Revenue Canada has developed for tax gathering lend themselves to supervising the nonprofit sector: *see, e.g.*, Weisbrod, B., *The Nonprofit Economy* (1988) 165 who concludes that a tax gathering service cannot serve as the principal regulator of the nonprofit sector nor facilitate attaining the social goals of efficiency and equity that sector pursues.

70. DeMott, *supra* n. 6, 144.

difficult in B.C. for government because of fears that the information will encourage, or be seen by certain parts of the electorate as encouraging, pre-marital sexual activity.

2.11.3 Some believe that at least purely business decisions are capable of being reviewed by government, to make sure that public funds are not wasted in economically unwise activities. But there is reason to doubt whether even this limited responsibility should be assigned to government.

### 2.11.4 Example

**A government agency that promotes economic development guarantees loans to producers of films in the province. The program attracts heavy losses and government decides to no longer support film production. A society funded by government, however continues to fund local film producers.<sup>71</sup>**

When the media carried this story, some expressed the view that public funds should not be invested in any enterprise that business or a crown corporation refuses to back.<sup>72</sup> But many people in the community would agree that grants can be made for legitimate non-commercial objectives. The purpose of funding an activity might be to stimulate a promising, untapped new industry. It might be to promote or preserve cultural perspectives. The fact that government abandons direct involvement in an area is not in itself a conclusive reason for barring the involvement of nonprofit organizations. The past decade has witnessed government gradually disengaging itself from many areas where community groups and volunteers have stepped in.

2.11.5 In many circumstances the distance that government interposes between itself and those agencies selected to decide on the application of funds is entirely appropriate, provided the boards of the nonprofit agencies that administer the funds are bound to abide by sensible conflicts of interest rules. Societies that attract controversy will find it difficult to raise funds unless, notwithstanding their critics, they also enjoy the support of other parts of the community. Nonprofit agencies, from time to time, will use public funds in questionable ways, or at least in ways that do not attract the support of a majority of the population. But we expect that this is a price that must be paid in the interests of the undeniable good work carried out by the nonprofit sector. Alternatives to this model are likely to be less satisfactory. Moreover, the advantages nonprofit agencies enjoy over government are lost when government attempts in any serious way to monitor a society's activities and to require a society to account for funds. The model works--that is, placing funds in the hands of autonomous bodies and trusting them to use them effectively--only when the people who receive the funds can be trusted. That is why these people must be subject to high ethical standards, the kind reflected in the suggestions for changing the conflicts of interest rules outlined in this Report.<sup>73</sup>

## 2.12 Summary

2.12.1 Some see no need to change the law, but most who commented on the CP agreed that director self-dealing should not be allowed. The current rules provide no guidance about conflicts of interest. People frequently do not recognize conflicts of interest when they arise. When recognized, there is doubt about how to deal with them. Steps must be taken to make sure directors have a firmer grasp of their responsibilities.

2.12.2 The answer, as outlined in Volume I of this Report, is to provide clearer rules about which conflicts of interest are unacceptable. In this way directors can govern their conduct accordingly, while others can judge more effectively whether appropriate decisions are being made.

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71. Letters to the Editor, *Vancouver Sun*, Sept. 29, 1994 A18; D. Kunin, "Public money doesn't belong in risky investments," *Vancouver Sun*, Sept. 27, 1994 B2.

72. *Ibid.*

73. Even if funding bodies cannot supervise the application of funds, it is open to them to determine whether organizations they support have in place adequate ethical standards for dealing with many kinds of problems, including conflicts of interest. An effective method of ensuring that societies "voluntarily" adopt appropriate conduct guidelines is to refuse to fund them if they do not: see, e.g., J. Bryden, "Marleau calls for restraint in reproductive technology," *Vancouver Sun*, July 28, 1995 A5, where government announced no federal funding will be available for organizations that do not abide by voluntary government guidelines concerning reproductive technology. As a matter of good practice, most universities have adopted standards of conduct, or ethical guidelines, to be observed by faculty and staff. Because universities are comprised of so many diverse endeavours, they tend to adopt comprehensive standards of conduct. Responding to concerns about academic integrity, Canada's three granting councils announced that universities without appropriate policies in place by June, 1995 would no longer be funded by them: see, further, R. Cannata, "UBC, SFU 'advanced' on fraud, ethics issues," *Vancouver Sun*, June 14, 1994 B16. The article discusses the "Concordia Report" which examines this issue and calls upon the federal granting councils--the Natural Sciences and Engineering Research Council, the Social Sciences and Humanities Research Council and the Medical Research Council--to also assume responsibility for investigating misconduct. This is a good example of the power a funding body can use to ensure that recipients of grants adopt reasonable practices.



#### 3.1 Introduction

3.1.1 The discussion in this Chapter leaves the general issue--should the conflicts rules be revised?--to address a more specific question that arises from changing the rules so that a board can authorize only some transactions affected by a conflict of interest. Which transactions should be considered allowable?

3.1.2 Our correspondents offered suggestions about the following kinds of transactions:

- discounted transactions
- transactions beneath a threshold
- examples of beneficial director self-dealing
- director remuneration
- transactions between societies
- unconditional gifts
- tax motivated transactions

These are discussed in this Chapter.

#### 3.2 Discounted Transactions

3.2.1 Some felt that discounted transactions with a director were entirely acceptable:

...We are concerned that...[the suggested reform] may not allow some necessary and legitimate transactions. In particular, it may not allow transactions with third parties from which Directors or related persons might derive a benefit even if the benefit is a payment for goods or services and the benefit is less than the normal cost of those goods or services.

An illustration from our organization may help to illustrate this problem....[The society funds environmental litigation. Grants made by the society are typically used to engage a lawyer.] [The] grants will only cover professional fees up to a maximum of \$50.00 per hour. Grantees are permitted to “top-up” professional fees in excess of this amount, as long as the lawyer providing the service does so on a partial pro bono basis. Often...grants are made to citizens' groups to hire lawyers who are either directors of [the society] or who are professional partners or associates of [society] directors. [Society] policy is that a director will not take part in a grant decision if the grant applicant is a client or prospective client of the director's firm. We are concerned that the draft legislation would in many cases forbid grants to organizations wanting to hire a director or an associate or partner of a director.

We suggest that [the draft legislation] be amended to permit transactions with third parties from which directors or related persons might derive a benefit if the benefit is a payment for goods or services and the value of the benefit is less than the normal cost of those goods or services. This could be done by extending section 7(2)(c) to transactions with third parties and specifying that “financial advantage” does not include payments at less than normal cost for services rendered.

3.2.2 One group said that directors did not benefit by discounted transactions. Such transactions were really cases where the director conferred benefits on the organization and its members:

...We believe that being able to provide the Association with needed goods and services at a discounted rate should be a way in which a volunteer can contribute to the organization.

3.2.3 The problem is the difficulty of identifying a true discount. Smart comparison shoppers learned long ago, for example, that fair market value is often represented by a range of prices, not a single price.

3.2.4 **Example**

**A society requires legal services. Most lawyers bill on an hourly basis. Is a society better off dealing with lawyer A, who provides 10 hours of services but charges for only 6, or with lawyer B who does the same work in 5 hours, each of which is billed in full?**

The promised discount may be illusory. Even if it exists, to what degree is it an assurance the society received the best deal or value for its money?

### 3.2.5 Example

**Director A, a drywaller, offers to complete a project at a discount of 10 per cent less than any other quotation the society receives. Director A is awarded the contract. Director A schedules the work around other jobs and completes the project a month after the society expected it to be finished. The work is substandard.**

In the example, the society would probably be better off paying a non-discounted price and have the project completed on time and according to specifications. Perhaps Director A will correct some of the deficiencies. In non-arms length relationships, however, other directors may find it difficult to be critical. We realize, of course, that in many cases a self-dealing director will do a good job, perhaps far exceeding what might be expected in a typical business transaction. But it will not always work out that way. When a director is in a business relationship with the society, there is usually no way to isolate those factors which, in one way or another, have some impact on furthering the director's personal interests. The business nature of these transactions must inevitably interfere with the director's responsibility to ensure that the society (and its members) get the best deal possible.

3.2.6 Even so, the draft legislation in the CP recognized that *heavily* discounted transactions did not pose the same kinds of problems.<sup>1</sup> It allowed transactions so deeply discounted that any profit motivation must necessarily be absent.<sup>2</sup> This policy has been carried forward in the draft legislation set out in Volume I of this Report.<sup>3</sup>

## 3.3 Transactions Beneath a Threshold

3.3.1 It was argued in one submission that the new rules should only apply to larger societies, and then only larger transactions:

There should be a de minimis rule built into the definition of "transaction". My suggestion is that the proposals only cover transactions which exceed the greater of:

- (i) \$10,000 in value, or
- (ii) 10 per cent of the annual budget of any society.

The concern is to protect small societies that might not be well equipped to interpret and apply conflict rules.

3.3.2 The suggested threshold causes us some concern. The entire annual budget of some societies may not exceed \$10,000. The more limited the resources available to a society the more concern

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1. S. 7(2)(a)(i) of the draft legislation recognized an exception for a transaction which was in substance a gift. S. 7(2)(a)(iv) recognized an exception for a transaction "which manifestly represents benefits to the society so substantial that no other decision makes economic sense."

2. These transactions may represent some potential for substandard results, but a society must be allowed to take advantage of what are essentially donated goods or services.

3. See the *Director Transaction Rules* in Schedule B to the draft legislation.

there must be that they not be misapplied. Small societies are as entitled as large societies to expect fidelity from their directors.<sup>4</sup>

3.3.3 Perhaps the underlying concern here is a point that has already been discussed: conflicts rules are unnecessary for transactions involving truly petty amounts of money. But societies will, as a matter of course, overlook minor conflicts of interest arising in transactions for very small amounts of money.

### 3.4 Beneficial Self-Dealing

3.4.1 Many transactions, notwithstanding a conflict of interest, are beneficial and must be allowed.<sup>5</sup>

...a total prohibition against any conflicts of interest by nonprofits would be too severe, for it would carry in its swath useful interested transactions that nonprofits, particularly smaller ones, need to survive. An absolute ban ignores the reality of much of the charitable sector. Nonprofit corporations must engage in transactions with their directors in order to survive. Generally, few people have as much interest in the welfare of the nonprofit or understand it better than its directors. Interested transactions are efficient. The transaction costs are low. Interested directors may be able to lend money or provide services or do business with a nonprofit at a lower rate because they know the organization best. Because the organization may not be able to obtain equivalent goods in the market, these benign interested transactions may be the only source. A nonprofit would often lose advantageous opportunities otherwise available to it if it were completely barred from entering into any transactions with any of its directors or any entity in which the directors have an interest.

3.4.2 Here are additional reasons in favour of allowing some kinds of transactions that we heard during the course of consultation:<sup>6</sup>

- perhaps the director is the only one who will do the work.

#### Example

**The society requires legal services but the community is small. Its few lawyers are overworked and do not wish to bother with poorly paid society matters. One board member is a lawyer who will accept the work.**

- perhaps the director is the only one who can do the work.

#### Example

**The society requires the services of a veterinarian, but the community is small and the only veterinarian is a board member.**

- there are collateral non-financial benefits.

#### Example

**Board members may find it more convenient to deal with a director who is more accessible than a person hired in a truly arms-length transaction.**

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4. We are sensitive, however, to the goal of protecting smaller societies from having their activities disrupted by unrealistic and unmanageable conflicts rules. A few refinements to the approach set out in the CP that might provide some comfort to these correspondents are canvassed in this Report. They are: 1. allow privately funded societies to opt out of the new legislation; 2. structure the new rules in the form of guidelines rather than legislation; and 3. adopt an approach that sets out more general rules for determining what are acceptable transactions, to give the board flexibility in dealing with these issues, but combining this change with a list of warning factors any of which, if present, should dictate that a transaction affected by a director's personal interests not be authorized (discussed in greater detail in the next section).

5. James J. Fishman "Standards of Conduct for Directors of Nonprofit Corporations," (1987) Pace Law Rev. 458.

6. Some of these repeat points canvassed in the CP.

- there are collateral financial benefits.

**Example**

**The director may be able to facilitate a reasonable transaction with a business he or she owns or works for but, for competitive reasons, be unable to negotiate a similar arrangement with another company.**

- there are practical difficulties avoiding the conflict.

**Example**

**A director may find it difficult to remain part of a board that is compelled by conflicts rules to deal with a bitter business rival.**

**Example**

**In small communities, the family and business ties existing among the residents mean that there are many technical conflicts of interest.**

3.4.3 The CP set out reasonably exacting rules for identifying acceptable transactions. The information we gained through consultation suggested that more flexibility is necessary.

3.4.4 The method selected<sup>7</sup> for introducing more flexibility is a two-step approach:

- (1) identify general categories of transactions that might, depending upon the circumstances, be acceptable providing various warning signs are not present, and
- (2) identify categories of warning signs.<sup>8</sup>

In this way, transactions will be permitted where:

- there is no conflict
- there is a conflict, but the transaction must be accepted for pragmatic reasons
- there is a conflict, but the transaction is acceptable for other policy reasons.

Under this approach, the board will be armed with all the discretion needed for dealing with conflicts of interest.

### **3.5 Director Remuneration**

#### *3.5.1 Importance of the Issue*

3.5.1.1 The issue that drew the most comments was probably directors' remuneration. These comments revealed that many societies are troubled by the issue, but are unclear about the applicable legal principles.

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7. See the *Director Transaction Rules* in Schedule B to the draft legislation.

8. See para 4.1, *Director Transaction Rules*, *ibid*.

3.5.1.2 The following paragraphs discuss these issues:

- may a society pay a director for services rendered as a director?
- may a society reimburse a director for expenses incurred serving as a director? If so, are there guidelines for assessing expenses that may be reimbursed?
- may a society pay a director for providing services in some capacity other than as director (for example, as an officer or employee of the society)?

### 3.6 By-Laws and Paying a Director to Serve as a Director

3.6.1 The members of a society decide whether directors may be paid for serving as directors. This question is determined under each society's by-laws.

3.6.2 Many societies adopt the Schedule B By-Laws set out in the *Society Act*. By-law 30 provides:

30. No director shall be remunerated for being or acting as a director but a director shall be reimbursed for all expenses necessarily and reasonably incurred by him while engaged in the affairs of the society.

3.6.3 Paying directors is usually regarded as bad policy,<sup>9</sup> even where directors routinely work long hours. Director remuneration is unlikely to be regarded as fair when members and volunteers of the society, as is typically the case, work for free.<sup>10</sup>

3.6.4 Those who commented on the issue were adamant that directors should not be paid. One person wrote:

Schedule B of the *Society Act* model by-laws Section 30 says "No Director shall be remunerated for being or acting as a director but a director shall be reimbursed for all expenses necessarily and reasonably incurred by him while engaged in the affairs of the society." This should be incorporated into the Act, not left in an appendix. To go the other way is going to do more harm than good.

### 3.7 Indemnity or Reimbursement

3.7.1 Reimbursing a director for expenses reasonably incurred in performing society duties is entirely appropriate. Several societies were apprehensive that the suggestions in the CP might prevent that practice:

- Our Society is a small one operating a [low cost rental complex for seniors] operated by volunteer members....To cover our own costs we sometimes have to charge these costs to the Society.
- In your brochure you indicate that directors should not "enter into a business transaction with the society, or otherwise receive money from it." I would trust that "otherwise receive money from it" excludes honoraria and

9. Moreover, fundraising options may be affected by whether or not directors are paid. It is a condition of receiving a gaming license, e.g., that directors of the society not be paid.

10. Paying some directors may also result in making unpaid directors think they too deserve opportunities to profit from dealing with the society. Where directors are paid, the same kinds of problems of monitoring pay arise as with directors of corporations and boards. See, e.g., F. Le Grys, "Controlling directors' remuneration," (1995) Sol. J. 96; D. Goold, "What's the excuse for huge salaries?" *Globe and Mail*, May 11, 1995 B13; Glaser, J., *The United Way Scandal: An Insider's Account of What Went Wrong and Why* (1994) 176. A lapsed private member's bill, introduced in Parliament by John Bryden, would have forced charities to disclose executive salaries. Critics suggested that disclosure might hurt fund raising. For one reason, executives of major charities are often very well paid: R. Eade, "Charities want executives' salaries kept secret," *Vancouver Sun*, May 26, 1995 A4; see also CP, "Charities bill left 'as dead as a doornail,'" *Vancouver Sun*, June 7, 1995 A6; S. Delacourt, "Losing interest," *Globe and Mail*, April 1, 1995 D1, D5. The position favouring payment has its advocates, who see it as a method of ensuring able people are involved in the agency's activities: see, e.g., T. Holland, "Fair recompense," (1995) 139 Sol. J. 82 (concerning the (English) Law Society, where the profession has voted to pay the president of the society, formerly an unpaid position, an annual salary. Even in situations where institutional investors hold large blocks of shares, there are problems asserting shareholder control over corporate management issues such as director remuneration: D.P. Prentice and P.R.J. Holland (ed.), *Contemporary Issues in Corporate Governance* (1993) 92.

expenses. Societies such as [ours] where the directors and members of committees have ongoing practice expenses must be allowed to continue to receive honoraria to offset those expenses, otherwise, [there would be serious jeopardy to the society] functioning in the most effective manner possible.

In contrast to the views expressed in the last extract quoted, it should be observed that some professions have historically never questioned the policy that directors should serve without remuneration, even where time spent as a director represents a loss in professional income that must be absorbed. The benchers of the British Columbia Law Society, for example, serve without remuneration, and it is only since 1991 that an honorarium has been paid to the Treasurer of the Law Society.

3.7.2 Even so, nothing in the CP suggestions, or in the Report, would prevent a society from reimbursing a director for expenses. This aspect of current policy would be carried forward.

3.7.3 What is embraced by the idea of reimbursement? Does it include an honorarium, as one correspondent asked? If a director must miss work for society business, another correspondent asked, could the society reimburse the director for lost wages?

3.7.4 A society cannot use the ability to compensate someone for expenses to make a disguised payment for services. A society cannot “reimburse” a director for lost wages, nor for separate business expenses incurred by the director as a result of serving on the board. Nor would an honorarium, typically a token voluntary payment in recognition of services, be protected as “reimbursement.”<sup>11</sup>

3.7.5 What kinds of expenses may be reimbursed? Out-of-pocket expenses incurred in society business, such as parking expenses or mileage would be good examples. Even substantial expenses can be recovered, such as the legal costs incurred by a director sued in the capacity of director.<sup>12</sup>

### 3.8 Paying a Director to be an Officer or Employee of the Society

3.8.1 The prohibition against paying a director for director services does not extend to paying a director for non-director services. A society, for example, can hire a director to be an officer or employee of the society.

3.8.2 The CP suggested prohibiting these arrangements. They place the director in an unnecessary conflict of interest. Some agreed with this position:

It is our belief that a director of a society should not be permitted to also be an employee of that society (and vice-versa) as this is an inherent conflict of interest.

3.8.3 Other groups were troubled by the policy. They saw nothing objectionable about hiring a director as an employee. We were told about societies that

- sponsor track and field events and pay directors to coach athletes,
- run National Life Saving courses and pay directors to teach,
- produce plays and pay directors who act in the productions.

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11. That is not to say that a society cannot pay honoraria in suitable circumstances. But the payment would not be protected as a reimbursement for expenses. An honorarium is, essentially, a gift denoting appreciation. A modest honorarium may be entirely appropriate. Large payments, however, could not be characterized as honoraria. The rules that apply will be those that govern any gift made by a society. Societies that conclude that directors must receive some compensation for their services, particularly in cases where directors give up income opportunities to serve, should make sure their by-laws provide that directors may be paid for their services.

12. *Blair v. Consolidated Enfield Corp.*, (1993) 15 O.R. (3d) 783 (Ont. C.A.) (on appeal to the S.C.C., Bulletin of Proceedings, Mar. 17, 1995, 562).

We were also told about board members who were paid for society work through government programs, such as U.I.C. grants or work opportunity grants.<sup>13</sup>

3.8.4 These arrangements are relatively common. They can be beneficial. But they raise the same problems as all other cases where directors somehow attempt to gain a financial advantage from a society whose interests they ostensibly protect.

3.8.5 Some societies have responded by introducing rules to minimize problems arising from the contract. One approach is to require the director to resign or take a leave of absence from the board for the term of the employment.<sup>14</sup> A refinement is to prohibit a director from accepting a paid position with the society for a defined period of time (two years, for example) after leaving the board. In this way there is some assurance that the director was not involved in negotiating advantageous terms for the position.

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13. Should any distinction be drawn based on the source of the money? Does it make any difference if a director is paid by the society directly, or by a third party? If there is a distinction, which we doubt, what should be the case where a grant for a particular purpose is first paid to the society which then pays the board member?

14. One submission argued that a leave of absence provides no measure of protection for the society and complicates matters for the employee's supervisor, who has a problem asserting authority over someone to whom the supervisor will eventually be answerable. If the employed director does not do a good job, will the supervisor be able to insist upon better work habits, or threaten firing the employee? Will the director retaliate upon returning to the board?

### 3.9 The Chief Executive Officer of the Society (CEO)

3.9.1 The aspect of director remuneration that proved to be most controversial centred on the director who is also the chief executive officer of the enterprise. It was argued that a general rule against allowing directors to be paid employees of a society should make an exception for the position of the CEO.

3.9.2 The following submission, opposed to allowing a CEO to be a director, canvassed the arguments comprehensively:

Directors of nonprofit societies, or at least charitable societies, should not be remunerated, and certainly the person who is hired as the Chief Executive Officer, usually called the Executive Director, should not be a voting member of the Board.

There is an inherent conflict of interest in such a position, and it is not satisfied by having him refrain from voting on his own salary. He has a conflict in very many decisions, such as the decision to begin a new project, which may add to his work load, or to end a project which may be seen as reducing his empire. Sometimes the C.E.O. puts a lot of energy into a high profile project to improve his own image. He may take the organization into national or international alliances for prestige or free trips, with no discernable benefit to the society. He frequently has the opportunity to promote his own interests over those of his employer.

The person who is in this position has a great deal of influence, being a full time person dealing with part time volunteers. He does not need the added power of voting. It reduces accountability. When employees vote, it obscures the lines of responsibility, (the world is full of fuzzy thinkers, don't encourage them). The only possible exception would be directors who are chosen as employee representatives.

3.9.3 Others who shared these concerns mentioned examples of situations where the executive director is naturally motivated to “empire build.” The CEO is in a conflict of interest on any issue having the potential to enhance or diminish the importance of the CEO, or add to or subtract from the CEO's workload. These were seen as reasons against a CEO being allowed to vote on any matter that might affect the prestige of the CEO, such as decisions about budget, staffing, or high profile projects.

3.9.4 The preponderance of comments favoured allowing a salaried CEO to be a voting member of the board. Most of these submissions, such as the following, gave us examples involving religious organizations:

- Our local congregations are properly administered, and function well, under a form of congregational church government in which the pastor is not only a member of the board, he is chairman of the board. In our case, the removal of this practice as suggested by the Commission would constitute an unnecessary, harsh interference in the conduct of the internal activities of a charitable, religious institution, which historically governs itself in accordance with the public good...

The type of decisions entrusted to our church boards are such that the pastor, as professional and spiritual leader of the congregation gives integral leadership. These church boards act on behalf of the congregation in approving programs, policies, property matters, and charitable and administrative expenditures. The pastor, as a professional and spiritual team leader gives vital direction, consultation, and leadership in the decision making process, even though the decisions are ultimately collective in a true congregational setting.

It has been our experience that this form of congregational administration has simplified congregational management, and has minimized the unnecessary duplication of time, money, communications and administrative details, which otherwise reduce the effectiveness of a voluntary organization.

This group adopted conflicts rules requiring “the pastor or any pastoral staff” to absent themselves from a board meeting when salary was under review.

3.9.5 A lawyer wrote on behalf of a number of societies who shared these views:



...our firm represents a great number of British Columbia incorporated societies which would be affected by legislation dealing with conflicts of interest and rules of conduct. Most of these societies are essentially religious in their purposes and almost all of them are registered charitable organizations under the Income Tax Act of Canada...the directors are normally the leaders of the religious institution, both in a business sense and in a religious sense.

Most frequently, this issue arises for religious societies when the leader of the religious group, usually a church pastor, minister or priest, serves as a paid employee and also as the religious leader of the group.

...In many places in your Consultation Paper, you refer to prevailing community standards. I believe that if you explore this further with small closely held religious societies that you will find that the membership of these societies not only want but insist that their leader functions as both a full voting director and as their senior employee.

3.9.6 The CEO problem is not confined to religious organizations, as another correspondent made clear with an example involving a musical society:

Person A is a professional classical musician of international standing. Since the opportunities to practise his art locally are less than he would like, he starts a society to promote classical music concerts. He is the dynamo behind the society, managing all of the concerts as well as the fund raising, corporate sponsorships, and grant applications.

The society is relatively successful in raising both private and public support and runs many series of concerns (both free and by admission) that are very well attended.

Many (but not all) of the concerts include or feature Person A's performances, hence the "conflict of interest".

Note, however, that:

- (a) the society almost certainly would not have been successful without the efforts of Person A;
- (b) Person A is clearly a popular musician who is able to draw audiences in his own right;
- (c) private supporters (and I suspect public ones also) were well aware that Person A played a major role in the management of the society as well as was one of the regular performers at concerts staged (and paid for) by the society;
- (d) many private supporters contributed (or at least paid for tickets) not in spite of but rather because Person A was both the manager of the society and one of the principal performers.

...[I]t would be a shame for the new law to prohibit situations such as the above.

### 3.10 Some Options

3.10.1 A strong case has been made out for recognizing an exception to the general rules suggested in the CP, and accommodating board participation by a CEO. As one correspondent pointed out, the views of even a non-voting CEO are given, by virtue of the office, a disproportionate weight. In most cases, whether or not the CEO is able to vote will be irrelevant. Other directors will naturally side with a person whose views they trust or who, because of closer involvement with the affairs of the society, has more information or experience about the questions in issue. It is an important point.

3.10.2 As indicated in Volume I of this Report, the comments we received led to a reconsideration of this issue. We have concluded that new legislation should allow a society to adopt by-laws which allow a director to serve as a paid CEO of a society (basically, the membership must decide on the rule that is appropriate for their society).<sup>15</sup> A society would be free to enact by-laws allowing the CEO

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15. To accommodate societies that currently operate with a paid CEO/director, this rule should apply only to societies incorporated after the new conflicts rules are enacted in legislation.

- to be a voting member of the board,
- to be a non-voting *ex officio* member,<sup>16</sup> or
- to not take part in board activity in any capacity,

as may be appropriate for their organisation and corporate structure.<sup>17</sup>

3.10.3 Societies that allow a CEO to be a voting member of the board might wish to consider adopting procedural rules to minimize conflicts of interest problems.<sup>18</sup>

### 3.11 Transactions Between Societies

3.11.1 The ability to incorporate a company or a society allows transactions to be structured in imaginative ways. Although a person dealing with a corporation is technically dealing with an independent legal personality, it cannot be entirely overlooked that a corporation is a vehicle for pursuing the interests of other legal entities. Look hard enough and it will be found eventually that some of these are composed of flesh and blood. If prudence dictates that conflicts rules should prevent a director from entering into a transaction with the director's society, are there reasons to be apprehensive about transactions between societies that share directors?<sup>19</sup>

3.11.2 The CP suggested that transactions between societies should be regarded as acceptable. The point was not specifically challenged in any correspondence on the CP, but two callers raised questions about the general issue. Both calls concerned decisions that had been made to wind down a society and transfer its assets to a new organization.

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16. As an *ex officio* member of the board, the CEO could participate in board debate, but not have a vote. This option might answer many of the concerns raised in submissions we received. The option, however, might not appeal to organizations that currently allow directors to serve as CEO's because they are comfortable with the arrangement as one of established tradition. Societies facing this issue afresh should consider whether *ex officio* status--which avoids the conflicts of interest problem--answers the practical needs of the organization.

17. The draft legislation in Volume I of this Report adds new subsections to s. 24 of the *Society Act*. Subs. (4.2) would allow a society to adopt by-laws permitting one director to be a paid employee. A society could use this option to have a paid CEO be a member of the society's board.

18. See, e.g., Report of the Standing Senate Committee on Banking, Trade and Commerce, *Regulation and Consumer Protection in the Federally-Regulated Financial Services Industry: Striking a Balance* (Nov. 1994) 73, which recommends that the CEO not chair the board. Requiring different people to hold these positions means that the chair is then well placed to make an independent evaluation of the CEO.

19. Other aspects of this issue are examined later when we consider the extent to which an indirect interest in a transaction raises a conflict of interest: see para. 7.4.3.

### 3.11.3 Example

**Society A, with some members in common with Society B, sells land to Society B at a serious undervalue, with the object of consolidating the societies to promote their similar interests more efficiently.**

### 3.11.4 Example

**Society A has funds, but a failing undertaking. Its board wishes to dissolve the association and transfer the property to a society with new objects.**

3.11.5 One author indicates the concerns that arise when a for-profit organization transfers assets and enterprise to a nonprofit organization. Similar observations could be made about transactions between two nonprofit agencies, or where a nonprofit agency transfers its undertaking to a company:<sup>20</sup>

A common situation involving hospitals, nursing homes, and educational institutions exists when a nonprofit organization is founded to be the successor to a proprietary institution. Shareholders and directors of the proprietary institution and directors of the charitable organization are the same. In these situations, the permissibility of the interested transaction depends upon whether fair value was given, whether the charitable organization was serving the directors' and former shareholders' private interests, whether similarly situated individuals, such as a doctor in a hospital setting, have equal but not greater access to the nonprofit's facilities, and whether the sale was an arms-length transaction or a device for the property owners to escape losses or to benefit personally from tax exempt status. The problem in this area is one of proof. The crucial inquiry is whether the director was acting privately in his own interest at the expense of the charitable corporation or the public.

3.11.6 The general policy identified in the CP--to allow transactions between "related" societies--is correct to a point.<sup>21</sup> Special problems arise with a transaction involving a transfer of a substantial asset or of a substantial portion of assets or that is a prelude to dissolving the society. But problems raised by the transfer of all or part of a society's undertaking transcend questions of conflicts of interest. They are already addressed in Part 7 of the *Society Act*.<sup>22</sup>

## 3.12 Unconditional Gifts

3.12.1 The draft legislation in the CP allowed the board to authorize unconditional gifts made to a society. Some found the reference to gifts baffling. What conflicts problems are posed by unconditional gifts? Why was it thought necessary to mention them?

3.12.2 Because the draft legislation allowed the board to authorize a transaction that was *essentially* a gift, it seemed reasonable to also provide that the board could authorize a transaction that actually was a gift. Including the reference to gifts was to clarify that they were unobjectionable.

3.12.3 Some submissions, however, cited examples where requiring a board to approve truly unconditional gifts might cause difficulties:

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20. Fishman, *supra* n. 5, 428-9.

21. While it is necessary to recognize the validity of transactions between related societies, it is also important to recognize the special conflicts issues that can arise in these situations. If the societies have a director in common, what is the director's position when the interests of the societies diverge or, if not their interests, then those of their members or clients? The same issues arise when two companies share a director. *E.g.*, a financial institution is usually not a single body, but structured as a conglomerate or family of institutions. Suppose the "institution," *e.g.*, consists of a public holding company that controls a number of wholly owned subsidiaries whose various boards have directors in common. To whom does a director owe duties when problems arise? Shareholders of the public company? Depositors who deal with the subsidiaries? This dilemma is referred to in the Report of the Standing Senate Committee on Banking, Trade and Commerce, *Regulation and Consumer Protection in the Federally-Regulated Financial Services Industry: Striking a Balance* (Nov. 1994) 75. *See also Fraser River Helicopters Inc. v. Pemberton Helicopter Services Ltd.*, [1995] B.C.D. Civ. 1003-01 (S.C.) where a person on the boards of two companies, in carrying out a fiduciary duty owed one, was found liable to pay damages for breaching fiduciary duties owed the other.

22. Part 7 sets out rules for transfers by particular kinds of societies and also for particular transformations such as, *e.g.*, a society becoming a company (s. 74).

- ...I realize some of the implications you are trying to avoid, but what about a person who wishes to remain anonymous? What about the Director who gives to the society on a weekly or monthly basis? Probably the largest example would be the churches.

I don't know how to change the wording to accommodate the thousands of actions of this type that happen weekly, but in some way these “unattached” gifts, and the anonymous donors need to be considered.

- You mention in the Consultation Paper you do not wish to deter donors from giving to societies. I believe if many people can not remain anonymous they will stop giving.

...In most situations, certainly all that I am aware of, regarding donations to a church or religious charity there is great respect for anonymity. Yes, donations are usually by cheque and certainly the Treasurer knows who gives what and issues receipts, but that is as far as the information goes. The rest of the board members don't know details. They do, of course know the total amount of donations each month, or term between financial statements, but never what each individual gives. The 'safe-guard' comes at the annual audit.

In fact, in my opinion it would be, or at least could be, very detrimental to the organisation if the Board knew all the donors and what they gave. Consider the thousands of pastors who would know exactly who in their church was paying their salaries and how that may colour their view of individuals in that church. In our own situation we have people donating to our organisation through their church to ensure even our Treasurer does not know who it comes from. There is danger of those donations stopping if they became Board knowledge.

3.12.4 These practical concerns argue against requiring board approval for true gifts. The draft legislation in Volume I of this report adopts a definition of “transaction” that excludes gifts.

3.12.5 Even in the absence of a statutory requirement to obtain board approval, there will still be circumstances where a director should be reluctant to be a party to an anonymous gift:

#### Example

**A director of a society is a majority shareholder in B Co. B Co. makes a substantial donation to the society with a view to encouraging a later business relationship.**

It would be appropriate for the director to disclose the relationship with B Co. to the board when the gift is made. Even if a board need not authorize a gift, it may choose to not accept.

### 3.13 Tax Motivated Transactions

3.13.1 Some tax planned transactions involve transfers of property by gift or purchase between a director and a society. Each party benefits by the transaction.

3.13.2 We heard concern that the suggested changes to the conflicts rules might upset tax planned transactions, particularly since many of these currently operate on a two-step basis under which the transactions are ostensibly unrelated and, for Revenue Canada's purposes, must not be connected.

3.13.3 An example of a transaction raising this concern would be a donation of property to a society (such as shares in a company). If the society is a registered charity, it can issue a tax receipt for the property. Later, the donor might elect to re-purchase the shares from the society for fair market value. This transaction maximizes tax benefits while placing funds in the society's coffers.<sup>23</sup>

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23. The value placed on the property for the original donation may be anything between the adjusted cost base of the property and its fair market value. The donor will usually select a value based on two objectives: maximizing the tax advantage that can be derived from the donation and minimizing the tax payable on capital gains. Suppose the shares cost the donor \$400,000 and, at the time of the donation, are worth \$1 million. The donor might value the shares at \$450,000 (presumably because, in the circumstances, this will produce the maximum tax deduction for the donor). The charitable organization, being exempt from tax under s. 149(1)(f) of the *Income Tax Act*, will not be liable for any capital gains tax. If the society requires funds, it will need to sell the property. The donor may wish to repurchase the property at fair market value. By donating the property first, valued at \$450,000, and then purchasing it back from the charity, the charity receives a \$1 million dollar donation (part of which has been financed by government), and the donor receives the maximum tax benefit from the donation while

(continued...)

3.13.4 The last section talked about unconditional gifts. The changes suggested there would protect the first stage of this transaction. The second stage, however, would not be allowed under the draft legislation in the CP. No exception exists for a director to purchase society property. This is, in fact, an area where many abuses arise.<sup>24</sup>

3.13.5 To protect legitimate tax planned transactions, however, the legislation should acknowledge an exception for a director who, in one form or another, redeems or acquires at fair market value, property previously owned by the director or by a person related to the director.

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23. (...continued)

also managing to change the adjusted cost base of the property to \$1,000,000 without paying any tax on the capital gain. That represents a substantial tax saving that will be realized in the future.

24. In England, legislation specifically prohibits a director from acquiring an asset of the company without shareholder approval: *Companies Act*, 1985, s. 320: see N. Le Poidevin, "Conveyancers and the director as purchaser," (1995) 139 Sol. J. 21.

## 4 Chapter IV

## WHICH SOCIETIES SHOULD BE SUBJECT TO THE NEW RULES?

### 4.1 Can One Size Fit All?

4.1.1 Is it reasonable to expect that a single set of rules will be appropriate for all societies? Societies differ in size, function and sources of revenue. A large society might require rigorous conflicts rules and procedures. A small society might find them irrelevant for the kinds of conflicts issues that will typically arise. A number of people who wrote to us thought that special sets of rules should be developed for different classes of societies.

4.1.2 California legislation, to take the example of one jurisdiction, adopts this approach.<sup>1</sup> It provides three different sets of rules for three different classes of societies: religious societies, public benefit societies, and mutual benefit societies.<sup>2</sup>

4.1.3 This section examines different kinds of societies and explores the extent to which they present special problems that require special rules.

### 4.2 Types of Societies

4.2.1 The starting point is to develop a list of the kinds of societies that exist. The following list is based on suggestions made by our correspondents on the CP. The headings are not mutually exclusive. Some societies will come within more than one of them:

- *recreational clubs*: established to benefit only the members (e.g. a golf club, or a cycling club).
- *mutual assistance societies*: such as the B.C. Automobile Association, or a society that runs trade fairs for its members.
- *political or quasi-political societies*: such as environmental societies and special interest lobbying groups.<sup>3</sup>
- *privately funded societies*: such as the Vancouver Foundation.
- *professional or quasi-professional societies*: such as societies regulating particular professions.
- *societies funded by quasi-public sources*: such as the Law Foundation, the Real Estate Foundation and the Notary Foundation.
- *societies with a charitable purpose*: such as the Heart Fund. These are almost entirely funded by public donation.
- *societies with a religious affiliation*.
- *quasi-institutional societies*: such as hospital foundations, schools, recycling operations and art galleries which are, in part, government funded.
- *entrepreneurial societies*: these societies operate a business but do not distribute profits.

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1. "Developments in the Law--Nonprofit Corporations," (1992) 105 Harv. L. Rev. 1578, 1591. The California innovations influenced the (U.S.) *Revised Model Nonprofit Corporation Act*, promulgated by the American Bar Association in 1987: L. Moody, "The Who, What, and How of the Revised Model Nonprofit Corporation Act," (1988) N. Kentucky L. Rev. 251.

2. Religious societies are societies associated with organized religion. The difference between public and mutual benefit corporations has been described as follows (Developments, *ibid.*, 1591, n.6):

...Public benefit corporations perform activities that serve the interests of society (for example, museums or hunger relief agencies). Although they may be funded by private donations, they do not seek to serve the donors directly. By contrast, mutual benefit corporations are funded by members who receive direct benefits from the corporation (for example, trade associations)...

3. Some examples of lobbying groups (not all of which are incorporated as societies): National Action Committee on the Status of Women; Canadian Labor Congress; Canadian Parents for French; the National Anti-Poverty Organization; Canadian Council on Smoking and Health; the Child Care Advocacy Association of Canada; the Consumers' Association of Canada; Physicians for a Smoke-Free Canada; the Ukrainian Canadian Congress; Canadian Ethnocultural Council. Societies with a political objective typically do not qualify for charitable status and thus do not enjoy the same level of support through public funds as other kinds of non-profit enterprises. Even these societies, however, have received generous support in the form of government grants through, e.g., the Western Economic Diversification program and the Canada Council, although more recently the availability of public funds has diminished for agencies that serve solely political causes as opposed to delivering necessary public services: CP, "Cut grants to lobby groups with axes to grind, MP says," *Vancouver Sun*, Nov. 30, 1994 A12; P. O'Neil, "Ottawa tackles groups getting federal cash," *Vancouver Sun*, Mar. 3, 1995 A6; Editorial, "A new culture at the Canada Council," *Globe and Mail*, Mar. 15, 1995 A22; CP, "Doctors join to buy ad attacking Liberal MP," *Globe and Mail*, Apr. 5, 1995 A2; Cliff Breitzkreuz, MP, "Tax Borrow and Spend: A critical analysis of Western Economic Diversification," (Jan. 27, 1995); M. Philp, "Funding crisis threatening NAC's work," *Globe and Mail*, Jan. 31, 1995 A4. S. Delacourt, "Losing interest," *Globe and Mail*, Apr. 1, 1995 D1.

4.2.2 Many kinds of enterprises are not restricted as to whether they can be conducted on a for-profit or nonprofit basis. The British Columbia *Society Act* allows people to incorporate a society to conduct nonprofit enterprises. A company will usually be used for commercial activities.

4.2.3 The scope of purposes or activities a society might engage in is described in section 2 of the *Society Act*:

2.(1) A society may be incorporated under this Act for any lawful purpose or purposes, such as national, patriotic, religious, philanthropic, charitable, provident, scientific, fraternal, benevolent, artistic, educational, social, professional, agricultural, sporting or other useful purposes.

The section also sets out specific limits on what can be pursued by a society. The prohibition against “carrying on a business, trade, industry or profession for profit or gain,” for example, is in section 2(1)(d).<sup>4</sup> Another option for carrying out nonprofit activities is to set up a co-operative under the *Cooperative Association Act*.<sup>5</sup> Some of the criticism we heard about new conflicts rules emanated from organizations incorporated as societies that might perhaps have been better served by the *Cooperative Association Act*. Those who argue that special rules should be tailored for special kinds of societies might be overlooking the importance of selecting an appropriate legal personality for the activities of the association.

### 4.3 An Exception for Entrepreneurial Societies?

4.3.1 The last category in the list--entrepreneurial societies--requires some explanation. Notwithstanding section 2(1)(d) of the *Society Act*, it is possible for a society to operate a business. The business however, must be run on a nonprofit basis meaning, basically, that profits made by the society cannot be distributed to its members but must be applied for society purposes.<sup>6</sup> In practice, most businesses are operated through companies because they operate on a for-profit basis, distributing net income to investors (the shareholders).

4.3.2 The choice between operating any particular enterprise on a for-profit or nonprofit basis often depends on its profit-making potential. Theatre companies, for example, can be set up in either way.<sup>7</sup> Projects unlikely to generate profits will be run on the nonprofit model. The enterprise will need the special protections and benefits the community confers on the nonprofit. For projects with a more commercial appeal, the company model works best.

4.3.3 One person who commented on the CP provided the following description of two entrepreneurial societies he was involved with:

- Both the society which I now run and the one I am starting are in the area of health care. Neither are or will be funded by government, although, as each has a tax number, they are both able to give charitable receipts. Both societies are run as businesses with the profits being ploughed back into research and improvements in the delivery of the services. With the cut back in government funding, I believe that the method of operation of these societies will be the norm rather than the exception in the future.

4.3.4 We have concluded that special conflicts rules need not be developed for the entrepreneurial society. Those running these kinds of enterprises must choose the vehicle that works best for them. The fact that the community accords special privileges to nonprofit enterprises is reason enough to expect directors of these organisations to adhere to strict standards of conduct which prohibit

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4. Some endeavours require government permission. *E.g.*, an orphanage requires the consent of the Superintendent of Family and Child Service; a hospital requires the permission of the Minister of Health; a social club that of the Minister of Financial and Corporate Relations; insurance services that of the Superintendent of Financial Institutions.

5. R.S.B.C. 1979, c. 66.

6. People involved in nonprofit associations may still be earning a good income, paid to them by the agency.

7. *See, e.g.*, A. B. Harris, *Broadway Theatre* (Routledge, 1994) Chapter 9.

or limit opportunities for personal profit. Those who cannot live within the new conflicts rules might consider incorporating their enterprise as a company or, if appropriate, as a cooperative association. Both of these are subject to the business model for conflicts.

## 4.4 An Exception for Privately Funded Societies?

### 4.4.1 Overview

4.4.1.1 The reason cited in the CP for revising the conflict of interest rules is the need to ensure that public money is applied appropriately. Three submissions suggested that in that case there was no need to require privately funded societies to observe the new rules:

- ...we concluded that the provisions of the *Society Act* and the law relating to fiduciary duties are probably sufficient to govern the conflict problems of directors of most societies which might be seen as [not] having a public obligation. We suggest that the [new] legislation governing standards of conduct of directors should apply only to directors of...societies...which receive government funds or are entitled to issue receipts for charitable donations deductible under the Income Tax Act.

We suggest that the legislation should state that the members of a society that has no public obligation may voluntarily decide to adopt the provisions of the legislation if they wish - perhaps by so stating in their by-laws, so that the 'adoption' is publicly known.

- The LRC outlined several examples of small private societies and possible conflicts. Frankly, we do not see these as much of a problem. Like a private business, the directors of a private society should be allowed to spend funds how they like within the bounds of existing legislation.
- I believe that it would be useful for you to explore in concept the idea of a closely held private society. Most of these societies are financed by and exist exclusively for the benefit of their membership. The directors appointed by these societies are normally directly answerable to their membership and will suffer very real consequences for any breach of conduct.

4.4.1.2 The comments we received suggest significant support for restricting the ambit of new conflicts rules. It is also true that the driving force behind the decision to adopt new conflicts rules is concern over the application of public funds. We are prepared, consequently, to accept an exception for privately funded societies which would allow their memberships to vote to opt out from the general rules.<sup>8</sup> We do not believe that the exception should lead to real difficulties. It would not be a license to pillage. People in small societies will continue to be expected to conduct themselves ethically, but different methods will be employed to ensure ethical standards are obeyed. In all cases, the ultimate safeguard is a concerned membership prepared to vote out of office directors whose moral standards lapse.

4.4.1.3 Another group argued that societies that receive only small amounts of public funds should be treated like privately funded societies. A significant amount of public funds must be involved to justify applying new rules:<sup>9</sup>

We feel the LRC should have made a clearer distinction between the 1,100 societies which receive significant public funding and the remaining 15,000 odd societies that for the most part exist for the private purposes of their members. We do not feel the LRC made an adequate case to involve any but those organizations which receive a significant portion of their funding from the public purse...

A related question is whether anything should turn on the source of the public funds. Before considering the first of these issues, it is necessary to consider the second.

8. See s. 2(3) of the draft legislation in Volume I of this Report.

9. Another correspondent suggested that new conflict of interest legislation should only apply to "reporting societies" which, typically because of their larger size, are required to adhere to increased disclosure requirements. See ss. 1 and 38 of the *Society Act* for the definition of reporting society and circumstances when a Registrar would designate a society to be a reporting society.



#### 4.4.2 Funding

4.4.2.1 The discussion in the following paragraphs considers four sources of public funds:<sup>10</sup>

- tax concessions
- direct and indirect grants
- licensed gaming
- service contracts.

Do these sources of public funding all raise the same or similar concerns about the application of the funds?

4.4.2.2 **Tax concessions:** Government provides tax benefits to support the good work of registered charities. The nonprofit sector delivers many important and essential services, often relieving government of the obligation.<sup>11</sup>

4.4.2.3 Concerns have been raised about whether charitable donations are appropriately applied.<sup>12</sup> The tax system provides penalties where an organization applies money raised for charity to other purposes, but it is impossible to monitor all charities for compliance.<sup>13</sup> The absence of external checks increases the importance of internal rules, such as conflicts of interest rules, to encourage the sound application of public funds by the organization.

4.4.2.4 **Direct and Indirect Grants:** Examples of direct and indirect grants were set out earlier.<sup>14</sup> It is our conclusion that societies that receive assistance from government in the form of grants (whether by a transfer of money or assets) should be subject to conflicts of interest rules appropriate for the application of public funds.

4.4.2.5 **Licensed Gaming:** During our work, some high profile cases emerged involving societies that, apparently, applied funds derived through licensed gaming for unapproved purposes. Conflicts of interest rules cannot ensure that public funds will be applied wisely, or put towards the purposes for which government was led to believe they were being raised. But they can close one door for misuse--opportunities for personal profit by directors--thereby encouraging directors to be vigilant in seeing that funds are applied to achieve the objectives the society has set for itself.

4.4.2.6 **Service Contracts:** Service contracts government enters into with nonprofit agencies cover a wide range of activities, from providing shelters for battered women, to running alternative schools, to delivering health services. These contracts resemble the kinds of transactions government enters into with a for-profit corporation. The CP concluded that funds applied through service contracts

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10. For a discussion of funding sources in the context of whether funding bodies can supervise the organizations they support, *see* para. 2.10.1-18.

11. Even so, there are some who are apprehensive about whether the favourable tax status accorded charitable donations will continue: CP, "Charities to make pitch to maintain tax credit," *Vancouver Sun*, Dec. 9, 1994: A coalition of charities met with the president of the federal Treasury Board, concerned that government may be considering cutting the charitable donation tax credit. Paul Martin, Finance Minister, said in February, 1994, that public assistance to interest groups should be reviewed. The Commons Finance Committee recommended (Dec. 8, 1994) no cuts to the tax credit for registered charities, but did recommend further study of the issue.

12. R. Matas, "Charitable donations begin at home and end up heaven knows where," *Globe and Mail*, Oct. 22, 1994 D1-2. The article discusses charitable funds--about \$100 million dollars of tax credits--that are applied to overseas ventures, some of which are arguably inconsistent with Canadian public policy objectives, such as, *e.g.*, donations to organizations linked to terrorists. *See also* K. Bolan, "Reform MP's claim: Sikh organization 'a terrorist group'," *Vancouver Sun*, June 6, 1995 B12.

13. *See* para. 2.10.12-2.10.18.

14. Para. 2.10.5-6.

should also be subject to the conflict of interest rules developed to apply to the application of public funds. Here is an example which suggests that this conclusion is correct:

### Example

**Society A and Society B both provide driver education courses. Society A receives a government grant to assist it in its work teaching high school students located in the lower mainland how to drive. Society B is engaged by government under contract to provide driver education courses to high school students in the interior.**

Why should different rules apply to these societies? Each has the same objects and each receives money from government to carry out its work. Can the form by which the money is made available have any significance in choosing the conflicts of interest rules that should govern the application of the funds?

4.4.2.7 Upon further reflection, the CP analysis on the issue may have been incomplete. It is useful, for the sake of comparison, to develop the example by adding another arrangement whereby government might fund driver education.

### 4.4.2.8 Example

**Society A receives a direct grant to deliver driver education.**

**Society B enters into a contract with government to deliver driver education.**

**Company C enters into a contract with government to deliver driver education.**

Does the source of the funds, or the way the funding is structured, provide any direction for selecting the conflicts of interest rules that should apply?

4.4.2.9 In each case, the organization in question provides identical services, but the conflicts of interest rules the CP would apply to Society A and Society B differ from those that apply to Company C because the organizations have different legal structures (something which has nothing to do with the source of the funds). On what basis can a distinction be drawn between the rules that should apply to Society B and to Company C? Isn't government's real concern, and isn't the public interest fully protected, if the services are delivered satisfactorily? Does it matter in these cases whether societies find it convenient, expedient or necessary to enter into business transactions with their directors?

4.4.2.10 Perhaps a significant factor, in answering these questions, is the extent to which it is possible to assess whether the services in question have actually been delivered. Where there is no way to assess how well the contract is carried out, more reason may exist to question how the funds are applied and to seek safeguards, such as stricter conflict rules, against waste and abuse.<sup>15</sup> Where delivery of the services is verifiable objectively, so that it is possible to determine that value was received, there would seem to be less reason to assert control over internal management decisions.<sup>16</sup>

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15. It has been suggested that the nonprofit sector is preferable to the for-profit sector in cases where it is difficult to assess performance, because the nonprofit agency has less temptation to "chisel" on the contract: H. Hansman, "The Role of the Nonprofit Enterprise," (1980) 89 Yale Law J. 835; A. Ben-Ner and B. Gui, *The Nonprofit Sector in the Mixed Economy* (1993). But the "chisel" factor is reintroduced where a director of the nonprofit agency has a business relationship with the nonprofit agency, because the director then has a personal profit motive.

16. Government is usually less concerned over how the money is applied--who it is paid to, e.g., or how much money is received by particular individuals--and more over whether the program actually produces results. The provincial government seems to have adopted this perspective, e.g., in its dealings with the Lower Mainland Purpose Society for Youth and Families. When the society's use of gaming funds was questioned, government provided direct funding to the society to deliver particular programs. Apparently because government was satisfied with the level of service received, it never requested the society to provide audited accounts: J. Hunter, "Controversial agency gets more than \$1 million in taxpayers' money," *Vancouver Sun*, Nov. 24, 1994 B5. See now, however, the joint Report of the Auditor General of B.C. and the Deputy Minister's Council, *Enhancing Accountability for Performance in the British Columbia Public Sector* (1995). Part II of this initiative will deal with developing an accountability framework for the relationship between government and funded bodies.

4.4.2.11 Suppose the contract is for something concrete, such as building a bridge or purchasing a car. The process of assessing performance in these cases is straightforward. Even performance of a contract to deliver driver education might be tested objectively by, for example, counting the number of graduates or testing them. These kinds of assessments are usually not free from difficulty, but results may be quantified in a variety of ways: the society may be able to produce statistics, for example, of the numbers of schools in which driving lesson programs have been set up, or the number of students enrolled in the classes, or the numbers of students enrolled in the classes who received driver's licenses after completing the course. Information like this will give government some idea whether the agency performed the contract adequately, or whether a competitor should be considered for funding in the future.

4.4.2.12 Other cases pose more difficulties in determining whether the contract has been fulfilled. Performance under a contract to promote plain language standards in legal documents, for example, cannot be realistically quantified. Any estimation of the success of a contract for services of this nature must necessarily be highly subjective.

4.4.2.13 What seems to emerge from this analysis is that when an agency receives “public” funds under a service contract, there are many factors that will determine the kinds of conflicts rules that should apply. Government contracts cover a spectrum of services. At one end, because of problems of verifying what is delivered under the contract, the people using the funds should be subject to very high conflicts of interest standards. At the other end, where the relationship involves quantifiable objectives, the business model may be entirely appropriate.

#### 4.4.3 *Policy*

4.4.3.1 Our preference is to accept that distinctions exist among for-profit enterprises, privately funded nonprofit enterprises and publicly funded nonprofit enterprises, but to go no further. Any B.C. society receiving public funds in whatever form, including under a service contract with a level of government, should be required to abide by the general conflicts rules for societies. We recognize that apparent anomalies may arise, but do not see this as a reason for adding to the complexity of the rules that apply to societies.

4.4.3.2 We heard from correspondents who were concerned that this step would restrict their flexibility and seriously hamper their activities. The draft legislation presents two options to a nonprofit organization that does not wish to abide by the conflicts rules for societies. It can

- decline any form of public funding. If it does so, its membership would be free to vote to amend the society's by-laws, opt out of the general rules and abide by the business conflicts model, or
- seek exemption (by an application to cabinet or the conflicts commissioner<sup>17</sup>) from the general rules.

4.4.3.3 There are a number of related scenarios that should be explored. What is the position in the following cases?

**Example (a):** a society opts out of the rules and then receives, unexpectedly, public funds. What rules should apply to it?

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17. The discussion of the possible roles that might be performed by a conflicts advisor/commissioner begins at para. 7.3.

**Example (b):** a society regularly receives nominal public support. Should it be able to opt out of the rules? Is token public support sufficient reason to require strict conflicts rules?

**Example (c):** a society receives substantial public support from time to time. Should it be able to opt out, and abide by the stricter rules only on those occasions when it actually receives public funds?

4.4.3.4 We have given some thought to whether new legislation should allow a society that receives no more than a limited amount of funds from public sources to opt out. But this is an approach which is likely to create a great deal of confusion about whether, and when, the threshold has been reached and which rules apply to the society and its directors. Even if this option were made available by legislation, a well-advised society should decline to take it because of the benefits that flow from adhering to well defined standards of conduct. These reasons led to the conclusion that this innovation not be incorporated into the new legislation.

4.4.3.5 It is also our conclusion that a society that regularly receives any level of public support, even if it is nominal (example (b)), and a society that expects to receive public support, even if the times it is received are irregular (example (c)), should not be allowed to opt out of the general rules. In neither case can the society qualify as one that receives no public funds.

4.4.3.6 A society, however, that receives no public support and opts out must be prepared to abide by stricter conflicts rules when it decides to accept an unexpected donation of public funds (example (a)). Where a privately funded society has opted out of the legislation and then receives any amount of public funds, its conflicts rules should be suspended to the extent that they are less strict than the general rules that apply to societies that receive public funds. The suspension should be limited to the later of

(a) one year from the date the funds are received, and

(b) the date the funds have been entirely depleted.

Where the funds are received in a stream, then the limitation on the period of suspension should not begin to run until the last date public funds are received.

## 4.5 An Exception for Societies with a Religious Affiliation?

4.5.1 Some suggested that the new rules should not apply to societies having a religious affiliation:

I suggest that the business model of disclosure and authorization works very well for...religious societies and I do not believe the defects of that business model apply in the same way to religious societies. Frankly, I cannot see how an employee who is an executive officer of such a religious society would have any different duties of a fiduciary nature to the society than he would have if he were simply a director. The standards of conduct for a director as set out in Section 25 of the *Society Act* are certainly expected of any executive employee of the same society.

...I believe that there is an enormous difference between a privately funded religious society to a publicly funded secular society. When the same rules must be applied to vastly different organizations you can have vastly different results and those results are sometimes quite inequitable. I suggest that this may be the case here.

4.5.2 We appreciate that these factors represent extra assurances of fidelity that help guarantee that funds will be applied in an appropriate manner. Nevertheless, we remain of the view that where public funds are involved, their application should be subject to strict conflict of interest rules.

## 4.6 An Exception for Societies With Well-Developed Rules?

4.6.1 One group suggested that rules of general application should not apply to societies that have adopted special rules developed with their particular activities in mind:

We do not feel the LRC made an adequate case to involve...other organizations, like [ours which regulates a profession] which already have in place extensive codes of ethical conduct...

In our case, as with all such professional associations, we have in place an extensive code of professional conduct which renders the additional legislation redundant. An Act of the provincial legislature extends to us the authority to deal with such issues, and it seems nothing short of gratuitous to return part of that authority to the legislature via another statute.

4.6.2 The draft legislation allows cabinet (or the conflicts commissioner) to exempt specific societies from the operation of all or part of the conflict of interest rules. We anticipate that the most important factor leading to such a decision will be that the organization is already subject to a different set of well-developed rules fine-tuned for the particular organization and its activities. We also anticipate that such an alternate set of rules will not find approval unless consistent with the philosophy underlying the general rules. On balance we feel that the interests of societies that have adopted special rules are met by this approach. Moreover, where a society adopts rules that set a stricter standard than the general rules, there would be no need to apply for an exemption.<sup>18</sup>

## 4.7 An Exception For Societies Subject to Supervision by Another Board or Body?

4.7.1 Three groups argued that a board could be given greater independence where it was subject to the supervision of another body. Four supervisory models were identified:

- (a) *model one*: the groups are arranged in a pyramid structure where organizations are answerable to other organizations that occupy higher levels of the pyramid and all are subject to the authority of the organization at its apex;
- (b) *model two*: an agency (or agencies of roughly equal status) create a supervisory board;<sup>19</sup>
- (c) *model three*: board decisions are subject to constitutional limitations, set out in the by-laws that govern the board and which restrict the range of decisions that may be made;
- (d) *model four*: an independent committee is constituted that sets standards or makes decisions in advance, that are then implemented by the board (in other words, decisions are made by selecting options from within the range of acceptable decisions identified by the independent committee).

The basic idea under the first two models is that the current law governing conflicts of interest works well where the directors are being watched. Under the third and fourth, that the current law works well when directors have their discretion fettered:<sup>20</sup>

- ...while endorsing the general direction of the suggested changes, and while affirming the need for charities to safeguard against “empire building” on the part of unfettered, independent, dominating individuals, we appeal to the Commission to recognize the legitimate role of pastors as chairman of church boards, where...

- b. the congregation is itself affiliated with a recognized denominational body which provides a process for external review, supervision, and discipline, in accordance with Conflict of Interest Guidelines provided in the

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18. See s. 2(2) of the draft legislation in Volume I.

19. E.g., reacting to the scandal involving Jim Bakker's PTL ministry, the National Religious Broadcasters established an Ethics and Financial Integrity Commission in 1988: “Developments” *supra* n. 1, 1591, n. 5.

20. This is the same philosophy underlying the CP model, only the limitations are imposed by statute.

Constitutions and By-laws of the denomination, and as defined from time to time by Revenue Canada Regulations regarding charities, and...

e. where management decisions taken by the board with the pastor as chairman are subject to limitations as provided in the constitutions, or as specifically approved by the local congregation.

- ...there are other checks and balances. The activities of [boards] are subject to the supervisory authority [of] a government appointed Board. Further, any order, decision or determination of a [board] is subject to appeal by any person who is aggrieved or dissatisfied by the order, decision or determination. The right to appeal is not restricted...
- In order to remove any individual bias or influence concerning the allocation of research dollars, the Foundation has a National Competition and Review process with both Canadian and International representation. The national review removes any individual bias over any one application for funding from the Foundation. In addition, the Foundation's stringent conflict of interest guidelines for its committees require openness and disclosure. Together, these activities create a process that addresses conflicts of interest. To illustrate, in 1994 three members of the 13 member Research Evaluation Committee were required to withdraw from the committee for an entire year of their appointment due to conflicts of interest.

4.7.2 As mentioned in the last section, it has been suggested that provisions be incorporated in the draft legislation to allow societies to be exempted from the application of the legislation. The factor that is likely to be most persuasive in such an application is the suitability of the rules by which the society wishes to be governed. We believe that the models described in this section may, in appropriate circumstances, be regarded as reasonable alternatives to the legislation we recommend.

## 4.8 An Exception for Private Foundations

4.8.1 We also received comments urging us to consider adopting special rules for societies that are “private foundations” under the *Income Tax Act*.

4.8.2 The *Income Tax Act* sets out special rules for charities that vary depending on whether (a) the charity carries out charitable activities itself or provides funds for other organizations to do so, (b) the charity operates with an independent board or the makeup of the board will be dominated by people who are related by reason of family, friendship or business, and (c) the charity has a variety of sources of funds or is primarily funded by one person or group.

4.8.3 A charity where the majority of its board is related (so that they are not dealing at “arms length”) or where more than 50 per cent of its capital is donated by one person or group is a “private foundation.”<sup>21</sup> These are two circumstances in which one would not be surprised to find conflicts of interest issues arise. There might also be some natural concern that the board of a charity structured in this way would be tempted to make decisions that benefit friends and family. Why is the private foundation recognized under the *Income Tax Act*? Ordinarily, one would expect the law, including the legal rules that reflect tax policy, to insist that charities be operated in ways that exclude the possibility that decisions will be affected by conflicts of interest.

4.8.4 As a matter of policy, government recognizes the concept of the private foundation because it is an effective vehicle for making private sources of capital available for community purposes. The cost to the public of tax benefits received by donors is more than made up by the overall benefit to the community resulting from the activities and projects funded by the private foundation.

4.8.5 Those who believed that the private foundation should not be subject to the new conflicts rules that would apply to all other societies argued that

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21. S. 149.1.

- the private foundation is, by definition, an organization where conflicts of interest must inevitably arise.
- Special conflicts of interest rules are not needed for private foundations because they are already subject to control by the *Income Tax Act* rules.<sup>22</sup>
- the *Income Tax Act* represents a careful balancing of interests and policies. Conflicts rules that do not recognize the special case of the private foundation may remove an important source of funds from the community.

4.8.6 We have considered this case carefully. In our view, the conflicts rules set out in the Report will serve private foundations well, but we are sensitive to the concern that technical conflicts, which lead to no harm, may arise that will present risks a donor may be unwilling to face. Suppose that a transaction that is acceptable under the *Income Tax Act* runs afoul of provincial conflicts of interest legislation. The transaction would be susceptible to being set aside, possibly triggering unexpected and harsh tax consequences to the donor. A person whose motives are benevolent would probably be unwilling to take these risks, and no advisor would be able to structure the transaction in such a way that a donor would have the necessary reassurances.

4.8.7 In these circumstances, it strikes us that if a conflicts commissioner is empowered to exempt a society from the application of the legislation (as we recommend) this would provide a complete answer. The society could apply to the commissioner for exemption for a particular transaction, or for a limited period of time. In rare cases, provided the private foundation had selected for itself adequate alternative conflicts rules, the commissioner might consider a permanent exemption.

4.8.8 The new legislation should recognize, as does the *Income Tax Act*, the special situation of the private foundation. The sections conferring power on the Commissioner to exempt a society from the operation of the legislation should specifically mention status as a private foundation as a factor that would justify an exemption.

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22. No part of any charitable foundation's income can be paid to, or otherwise made available for, "the personal benefit of any proprietor, member, shareholder, trustee or settlor:" s. 149.1(a); a private foundation will lose its registration if it carries on any business or fails to meet disbursement quotas set by the *Income Tax Act*: s. 149.1(4); special tax rules (under s. 189) apply where the foundation's money is used in investments (called "non-qualified investments") that benefit foundation insiders or major donors.

## 4.9 Application to Groups that are Not Societies

4.9.1 We received many calls from people involved in organizations that were not set up as societies but who, nevertheless, faced on a routine basis the kinds of issues addressed in this project. The CP observed, and it bears repeating, that the legal structure or personality of an organization does not affect the capacity for conflicts of interest to arise. Conflicts of interest are the natural outcome of having human beings involved in activities. The draft legislation in Volume I allows cabinet to make organizations that are not societies nevertheless subject to the new standards of conduct.

## 4.10 Conclusion

4.10.1 The foregoing discussion records the more important points raised by correspondents on the CP suggestions for changing the law on the issue of which societies should be subject to the new rules. The comments stimulated re-thinking on many issues and helped immensely in formulating the final recommendations in the Report. Basically, the new rules should apply where public funds are involved. Privately funded societies should be allowed to opt out of the general rules and private foundations should be permitted to apply for an exemption from them. Special rules are needed to govern the situation where a society opts out from the rules and then receives a small portion of its revenue from public funds.<sup>23</sup>

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23. The receipt of public funds would have to be an exceptional occurrence. A society that regularly receives public funds would not qualify as “privately funded” so that any purported reliance by it on the legislation to opt out would be invalid.



## 5.1 Introduction

5.1.1 Some people were less troubled by the idea of new conflicts rules than by the question of how they should be introduced. The CP set out the new rules in the form of draft legislation. Not everyone feels comfortable with legislation.

5.1.2 The suggestion was made by some that the new rules could take the form of conduct guidelines, much like those the CP suggested for society members. A number of reasons were advanced to support this approach, including the view that standards of conduct, while providing the necessary guidance, can be applied more flexibly than legislation. Here is a sample of comments received on this point:

- Legislation is not necessary - Code of Conduct guidelines as part of the *Society Act* regulations are adequate; and, the Code should apply only to bodies which receive significant public funding.
- I wonder if there needs to be absolute consistency in the application of these conflicts of interest rules to all kinds of societies or whether you cannot permit flexibility in the rules after you outline basic standards pertaining to conflicts of interest. I do believe that your standards of conduct rules are a very good beginning in this regard.
- I question the conclusion which you have come to that there is often an unwarranted exercise of discretion with unsatisfactory results. In order to prevent such an exercise of discretion, you are proposing legislation and rules. This is a rather interventionist approach. Frankly, I think we need less government and not more government in this particular area which has worked so well with volunteer labour and which provides such a necessary and vital part of our economy.
- A case can be made for implementing provisions to deal with conflict where significant amounts of public funds are involved. However, rather than all-encompassing legislation as proposed by the LRC to deal with the few problems which may arise, the simple solution would be to institute a regulation requiring those societies in receipt of significant public funds to adopt the Code of Conduct detailed in Appendix B on p. 131 of the LRC report. The advantages of flexible guidelines as laid down in a Code of Conduct as opposed to legislation are obvious, and in fact are supported by the LRC in its report. Legislation requires a significant list of exceptions - something the LRC addresses at length - and something is almost certain to be missed.

5.1.3 These suggestions describe a very promising approach. One of the quotations refers to the discussion in the CP outlining the differences between legislation and conduct guidelines. For convenience, we repeat that discussion here:<sup>1</sup>

Many people, particularly lawyers, ordinarily think of legislation as the best tool for setting out rights and obligations. But legislation has some obvious drawbacks. It really only works well for setting out firm rules. Modern legislation attempting a more flexible approach sometimes sets out a general rule, and then confers upon a particular person or agency, or the court, discretion to make decisions appropriate in the circumstances (*e.g.*, the *Family Relations Act*, R.S.B.C. 1979, c. 121, s. 51.) One criticism of this approach is that a discretion invites an individual to decide matters according to personal beliefs, leading to some inconsistency among decisions by different people.

The current rules for societies already import an unstructured discretion, with unsatisfactory results.

What seems to be needed are several levels of rules. At the highest level are invariable rules that should apply to all directors of all societies. Because circumstances seem to have such a heavy significance in determining whether there is a conflict and how serious it is, there are not many rules of such universal application.

At the next level are rules which may allow the board some discretion to determine whether, in the circumstances, a conflict exists and how to deal with it. These rules can also probably apply to all societies.

Eventually, however, the rules must recognize the significant differences that can exist between societies. Some rules must be geared to the particular circumstances of the society (is it a small social club? is it a large society carrying out

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1. *Consultation Paper on Conflicts of Interest: Directors and Societies* (LRC CP 71, 1993) 46-8.

public functions? does it make grants, purchase property, determine industry standards or professional qualifications, etc. or does it advise those who are responsible for any of these functions?). In some cases, these specific rules can operate in a black and white way. Others must operate more flexibly, in the sense that breaking a rule may not always be considered wrong or, if wrong, may not always be viewed as very serious.

It would be possible to use legislation to set out at least part of this hierarchy of rules, but the more specific to a situation the rules must be, the less appropriate legislation becomes. These considerations suggest that something is needed to supplement legislation....

Practices adopted by many societies and government agencies suggest the solution. They supplement legislation with standards of conduct the society or agency drafts itself.

Conduct guidelines have a number of advantages over legislation. They can incorporate more flexibility and cover more areas--such as setting rules that should be observed by people other than directors involved with the society. Conduct guidelines need not use complex drafting (which legislation sometimes must, in order to be precise). Rules set out as general guidelines are more likely to encourage ethical behaviour than principles prescribed in legislation, a point made by the Cadbury Committee when it recommended a code of business ethics for directors of companies:

Statutory measures would impose minimum standards and there would be a greater risk of boards complying with the letter, rather than the spirit, of their requirements.

Conduct guidelines can even include examples, something which is uncommon in legislation. Finally, the standards can be chosen with specific regard to the needs of the particular society (whereas legislation must ordinarily be of general application). To ensure that there is no vacuum of rules, legislation can set out model standards of conduct which apply to all societies that do not expressly adopt different standards of conduct.

5.1.4 Frankly, the idea of using conduct guidelines for everyone involved in the activities of a society was not considered when the CP was prepared. Because the conflicts of interest rules are currently placed in legislation it seemed sensible to use the same vehicle for new rules. But the points raised by our correspondents are good ones. Moreover, using conduct guidelines (a) addresses many of the apprehensions and criticisms expressed by other correspondents, (b) provides a statement of the essential principles, and (c) the necessary structure to distinguish between acceptable and unacceptable conflicts of interest:

- guidelines can be expressed in plain language
- they can be drafted to provide more information than legislation
- they can include examples (unlike legislation, which ordinarily only allows a firm statement of principle)
- they are easier to apply than legislated standards
- they are more flexible to apply than legislated standards

5.1.5 The draft standards of conduct set out in the CP were well received. We appreciate the concern over the difficulties of setting out ethical standards for directors in suitably rigorous language in legislation. Both of these points convinced us to explore, and finally adopt, the option of using guidelines to provide a board with guidance on whether to authorize a transaction.

5.1.6 It is our expectation that at least some of the minority opposed to the directions for reform discussed in the CP will find them more acceptable in the form of Director Transaction Rules we recommend, since the change in approach addresses so neatly so many of the objections they raised.

## **5.2 Conduct Guidelines for People Other Than Directors**

5.2.1 As mentioned, the draft conduct guidelines for all society participants published in the CP were universally applauded. Some societies adopted the guidelines outright, or adopted guidelines

based on them. It was apparent that many people saw the need for conduct guidelines. People also felt comfortable with both the approach to drafting and the policies advanced by the guidelines.

5.2.2 Appendix B of Volume I of this Report sets out conduct guidelines for society participants in the form of a Policy Statement. The Policy Statement is offered as an example of an approach a society might wish to adopt for dealing with conflicts of interests and other conduct issues involving members.

### 6.1 Good, Bad and Tolerable Conflicts

6.1.1 Many who responded to the CP seemed to assume that anything raising a conflict of interest was, by definition, bad. The society will suffer. The director is unethical. The public good will be harmed. It must not be allowed. This is far too simplistic a view.

6.1.2 Conflicts of interest may be neutral, if not neutral, trivial, even if more serious, beneficial. Simply being in a conflict of interest may have no practical significance whatsoever. The person with a conflict, for example, may nevertheless behave in highly ethical ways.<sup>1</sup> Sometimes the conflicting interest may help the director make better decisions than a director whose loyalties are undivided. Identifying the conflict of interest begins the process of determining how to deal with it.

6.1.3 The discussion earlier canvassed some aspects of non-negative conflicts of interest (*i.e.*, those that are neutral or trivial). It has also noted a few examples of benefits that may be derived from having directors who are in a conflict of interest. This Chapter provides more detail about situations where benefits are derived from having someone who has a conflict participate in particular activities or decisions.

6.1.4 For many reasons a society will want to have particular people on its board notwithstanding the fact that these people may, from time to time, have conflicting interests. Some reasons are practical, such as the belief that particular members on the board will enhance the society's ability to raise funds. Some are political, such as the desire to give effect to policies supporting issues such as avoiding gender bias or promoting multiculturalism. Some relate to the board's credibility, which may depend upon having

- an appropriate mix of viewpoints represented on the board
- people with particular experience or credentials
- notable members of the community, or
- members who have demonstrated ties with other organizations.<sup>2</sup>

6.1.5 Here are some examples:

- a society serving handicapped children insists that parents of the children serve on the board
- a society whose object is to promote the interests of a particular industry only allows people who are involved in that industry to be directors
- all directors of a society serving automobile dealers by, for example, putting on trade fairs, are representatives of the automobile dealers. In order to hold a trade fair, the society must enter into transactions with the dealerships
- grants made by an organization for heart research carried out by cardiologists must be decided by people expert in heart disease (namely, cardiologists)
- grants made by a society to fund environmental litigation must be decided by lawyers who are expert in environmental law

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1. Even in these cases, of course, the mere existence of a conflicting interest might discredit the particular director, the board or the society. It will be difficult to reassure outsiders that a person who is in a conflict of interest is not profiting from it.

2. *See, e.g.*, the suggestions for the composition of a board of directors in J. Fisher, *Money Isn't Everything: A Survival Manual for Nonprofit Organizations* (1977) 37. In some cases, satisfying these factors will be an essential part of ensuring the board is validly composed. *See, e.g., Blue-Red Holdings Ltd. v. Strata Plan VR857*, (1994) 50 A.C.W.S. (3d) 910 (B.C.S.C.), which concerned a decision made by a strata council for a building with mixed residential and commercial use. The council had no representatives from commercial units. The court held that for that reason the council was not constituted properly and that its decisions had no effect.

- a society that serves a particular sport enters into transactions with businesses also serving that sport, and wants representatives of these businesses to take part in society activities, including the burden of serving on the board
- societies that provide health services for a fee to particular sectors must have directors from the sectors they serve.

What is common to all of these examples is that a decision has been made to have people who are affected by the society's activities participate on the society's board. Typically, people involved in societies that carry out specialized work conclude that their decision makers, the members of their boards, must have particular qualifications to make informed choices. Unfortunately, those with the required experience are often in a conflict of interest.<sup>3</sup>

6.1.6 Similarly, societies will often want to make sure board decisions take into account the best interests of members and clients. For this reason, many societies require clients to be represented on the board.

6.1.7 People affected by a society's activities are known as “stakeholders.” By definition, a stakeholder is in a conflict of interest. We call this category of conflict “stakeholder representation.”

## 6.2 Comments on the Stakeholder Representative Exception

6.2.1 One of the most important, and the most intractable, of the issues met in this project involves stakeholder representation. The vast majority of all calls on the CP were from people struggling with how to deal with conflicts of interest problems posed by stakeholder representation.

6.2.2 The draft legislation in the CP dealt with these issues in s. 7(2)(b) and 7(2)(c)(ii) (the “special group” sections). In retrospect, judging from the comments we received, the CP could usefully have devoted more space to discussing the issues. The discussion in this Chapter is intended to remedy that oversight.

6.2.3 Correspondents raised, basically, four questions:

- should stakeholder representation be allowed?
- would the LRC suggestions allow stakeholder representation?
- what further steps should a board take to safeguard against conflicts of interest where it has stakeholder representation?
- are there any rules whereby a director, and a board, can determine when the conflict of interest comes too close to allow the director to participate?

6.2.4 Most people overlooked the “special group” sections<sup>4</sup> and automatically assumed that the LRC proposals would bar stakeholder representation:

- ...As just one example, we would like to point out that such a Bill technically would result in the dissolution of virtually every co-operative housing society in the province. Housing societies are made up of residents and all residents receive subsidized housing. Therefore all would be in a conflict of interest position and unable to continue serving

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3. If the group is large enough, it is usually possible to assemble an independent board of people. The smaller the group, of course, the more difficult this task becomes.

4. As well as s. 6(2)(f) which dealt with transactions that relate “to participation in activities the society regularly makes available to its members.”

under the provisions of the proposed legislation. Would these housing societies be better served by a board which contained no residents, assuming outside volunteers could be found to serve on them? We think the answer is self-evident, and use this illustration as an example of why we feel the proposal goes too far.

The “special group” section, in fact, would permit the relationship.<sup>5</sup>

- Nor is it always true that conflict of interest (as you have described it) is a bad thing. Not only is it a motivator when financial motivation is missing, it is often the people with a vested interest that most need to be making the decisions. There is a reason [our society's] constitution REQUIRES a minimum number of parents.

Should a member of a club have to resign membership before accepting a position on the board of directors? Should we ban parents from sitting on the School Board? Should we insist that anybody elected to Parliament move out of Canada?

Clearly not. We want the people making the decisions to be affected by those decisions. What we don't want is for them to benefit from the decisions much more than someone else in a similar situation. That, I believe, is where the dividing line should fall between acceptable and unacceptable behaviour of a director.

- The availability of expertise in [a particular medical] science at the Board level is essential to the continuity of sound scientific input at the highest level of decision-making. Participation from this professional field is not only encouraged but required. This not only serves to qualify the Foundation's scientific activities with sound input but also serves to promote the worthy goal of philanthropy and voluntarism in the scientific community....

A key limitation to the Foundation in obtaining leading volunteers in science is the limited size of B.C.'s health research community. For instance, of the approximated 9,000 physicians registered in B.C., only 46 are [specialists in this medical field].

Clearly, the availability of this expertise for the Foundation is limited and conflict of interest legislation should not inadvertently deny access to this body of knowledge for the Foundation.

We followed up these concerns with all of these correspondents to discuss the “special group” sections.

6.2.5 Even correspondents who considered the “special group” sections, however, were unclear about how they might operate in connection with their own societies. In every one of the following examples raised in submissions to us, the draft legislation would have tolerated the identified conflict:

- [Our society is] constitutionally bound to have at least half the directors be parents or primary caregivers for a person with a mental handicap. Under the rules as you propose them, any parent who joined the board of directors would have to pull their children out of all programs that the society offered. It is already hard enough to get the parents to volunteer (who have little spare time raising a child with special needs). Your changes would result in [our society] undergoing a constitutional crisis.

- Both the society which I now run and the one I am starting are in the area of health care....

The boards of directors of these societies are and will continue to be made up of representatives of the various constituent organizations which have an interest in the services being provided by these societies. This is as it should be as the services provided benefit the constituent organizations.

However, the relationship between the societies and their constituent organizations is not an occasional transaction, but a regular ongoing relationship. It would appear that under your guidelines, the common directorships will by definition create a “conflict of interest” and each transaction will be subject to scrutiny and either prohibited or requiring an involved procedure. In that the reason these directors are on the boards is to look after the interests of their constituents, surely this is an unreasonable impediment.

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5. If, in fact, the housing society is incorporated under the *Society Act*. Cooperative associations are actually incorporated under the *Cooperative Association Act*, R.S.B.C. 1979, c. 66, Part 2, “Housing Cooperatives.”

- The proposed rules are very detailed and very restrictive. It is our client's view that they will inhibit new projects and new initiatives. The Association's boards are composed of volunteer...principals, all of whose companies are members of the Association. They run, for example, trade shows in which their dealerships together with our dealer members purchase space to exhibit their [products]. Since the proposal provides that a director may not take part in a board decision about a transaction if the director might derive a benefit, it is possible that the show would not take place since all directors are interested. Instead of protecting members, the proposed rules would in fact harm them.

Interestingly enough, the problem raised in the last submission--all directors being unable to participate in board decisions because of a conflict of interest--exists under the current rules, which only seem to work in this case by ignoring them.<sup>6</sup>

6.2.6 Judging by the reaction summarized above, the CP proposals appear to have highlighted issues that the current law largely masks. Many correspondents, however, recognized that the problem was one that could only be addressed by developing special rules. One correspondent observed, for example:

I would be particularly interested in your assessment of the role and potential conflict of government employees sitting on Boards on behalf of their respective government departments. I had noted that decisions were then made for the benefit of the government department and its minister at the expense of the best interests of the particular society. The government employees, in my assessment had particular difficulty in understanding such a conflict. This issue I suspect, will become much more paramount as the various regional boards of health are established under the new health programs.

6.2.7 Can draft legislation set out special rules for stakeholder representation? The problems that arise are various and numerous and do not lend themselves to a single solution. This strikes us as another area in which legislation must recognize the conflict and forge an exception for it, but each society must develop for itself rules to safeguard against inappropriate decisions. Some examples of approaches:

- balancing stakeholder directors with non-special group directors,
- ensuring that the chair is both impartial and, perhaps, has a casting vote,
- setting out rules as to whether (or when) a stakeholder director can (perhaps must?) vote in favour of the interests of the special group as opposed to those of the society, or the general public.
- setting out rules regarding the participation of the director in the society or in the activities giving rise to the conflict (or regarding participation in the outside activities that give rise to the conflict).
- setting out rules regarding how confidentiality issues should be dealt with.

6.2.8 What constitutes an appropriate set of rules will depend upon a number of factors, such as the activities of the society, the identities of the participants, the nature of the conflict, and the

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6. The draft legislation set out for discussion in the CP would seem to present only a partial solution to this particular issue. Legislation must ensure that, where the source of the conflict is traceable to the need for special group participation, not only can the transactions be authorized but that the directors can participate as may be necessary in board decisions: see s. 4(3) of the draft legislation in Volume I.

functions performed by the board.<sup>7</sup> Societies facing seemingly similar problems might, because of other factors, find it necessary to employ different solutions for them.

6.2.9 Stakeholder representation issues take on a new dimension when they arise from cultural identity. One society wrote to us about the special problems encountered by First Nation societies:

As a First Nation society, cultural beliefs and customs have also been a dilemma.

Namely:

- leave without notice to enter into the Longhouse;
- absentee/tardiness due to Longhouse activity;
- extended family situation makes it almost impossible to prevent conflict of interest cases.
- extended leaves for funerals/bereavement.

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7. Stakeholder representation is a common feature of peer review procedures set up to hear complaints about professionals. Doctors, *e.g.*, sit in judgment on complaints about fellow doctors, police on complaints about police, judges about judges, lawyers about lawyers. The unusual aspect about peer review is that the traditional model is based not on the idea that there should be some stakeholders, but on the idea that the reviewing panel must be made up of those stakeholders who are the peers of the person against whom a complaint is made. For one reason, these are often the only people who have the training, knowledge and experience to be able to adequately judge the matter: *see, e.g., Voplobatuke v. Alberta Land Surveyors' Assn.*, (1995) 55 A.C.W.S. (3d) 440 (Alta C.A.). In fact, professions that do not set up such complaint procedures are subject to criticism because without them the only recourse is to the courts: *see, e.g.*, "Surveyors fail consumer check-up," (1995) 139 Sol. J. 307, which observes that the (U.K.) Consumers Association has made just such a complaint against the Royal Institute of Chartered Surveyors. A number of points can be raised in favour of peer review. Members of the panel are well placed to understand the circumstances of the case. They have the specialised knowledge often necessary to arrive at an informed decision. They bring an appreciation of what it is like to practise the profession of the person against whom the complaint has been lodged. When judging the case they have an interest in protecting the reputation of their profession. Endorsing a wrongdoer's conduct would reflect badly on everyone in the profession: *see, e.g.*, M. Fitz-James, "Court upholds peer review process for B.C. doctors," *Lawyer's Weekly*, July 15, 1994 35 commenting on *Millar v. College of Physicians and Surgeons of B.C.* In another matter, the Quebec College of Physicians concluded that a plastic surgeon was guilty of sexual assault on a patient when earlier criminal proceedings had led to an acquittal: R. Mackie, "Acquitted by court, MD convicted of sex assault by college," *Globe and Mail*, Apr. 13, 1995 A3. A case in which an application for leave to appeal to the S.C.C. has been filed raises the issue whether a Hospital Board consisting of lay persons is qualified to make determinations relating to a physician's competence that are contrary to those of the College's Medical Advisory Committee and Credentials Committee, whose members are doctors: *Shepherd v. The Colechester Regional Hospital Commission (N.S.)*: S.C.C. Bulletin of Proceedings, Apr. 28, 1995 738. Even so, criticisms of peer review have emerged in recent years. Peer review procedures for police, judges, lawyers and doctors have been the subject of some reconsideration. We do not single out these sectors as providing particularly egregious examples of problems that arise from peer review. Quite the contrary, they are examples of honest efforts to improve review systems to restore and maintain public confidence in these systems. Recent developments in these areas provide good examples of the kinds of approaches that are needed to reinforce public confidence in cases where stakeholder representation is required.

*For police peer review procedures, see the Report of the Commissioner, the Honourable Mr. Justice Wallace T. Oppal, Closing the Gap - Policing and the Community* (1994) I-2; N. Hall, "Police Act 'little use' in probing top brass," *Vancouver Sun*, June 13, 1994 B4. The B.C. government has indicated that a new process for dealing with complaints about the conduct of police officers in municipal police forces will be introduced: *Province*, Feb. 2, 1995 A17; "Professor to advise A-G about new process for police complaints," *Vancouver Sun*, July 8, 1995 A6.

*For peer review procedures for handling complaints against federally appointed judges, see, Editorial "A court for the judges," Vancouver Sun*, Aug. 23, 1994 A12. C. Schmitz, "Judges face record number of complaints," *Lawyers Weekly*, Feb. 17, 1995 4. S. Bindman, "Judicial Council to draft rules of behaviour for federal judges" *Vancouver Sun*, Oct. 14, 1994 A5; S. Bindman, "5 judges reprimanded, 3 quit after complaints over conduct," *Vancouver Sun*, Jan. 25, 1995 A6. S. Fine, "Complaining about bad judges isn't easy," *Globe and Mail*, Mar. 24, 1995 A6. Nova Scotia has been developing standards and procedures to deal with complaints lodged against provincial court judges: D. Moulton, "N.S. Bill will establish discipline process for judges," *Lawyers Weekly*, Dec. 16, 1994 40. A report to the Canadian Judicial Council recommends amending the procedures for handling complaints to make them more visible. The hearing should be public and the panel should include a lawyer and a lay person, not just chief justices: M. Friedland, *A Place Apart*, (August, 1995).

*For lawyer peer review procedures: see the (U.K.) Courts and Legal Services Act 1990*, which creates the post of Legal Services Ombudsman, whose duty is to oversee the way in which complaints against lawyers are dealt with by the relevant self-regulating professional body.

*For peer review of complaints by patients against doctors see Recommendations of Committee: Crossing the Boundaries: The Report of the Committee on Physician Sexual Misconduct*, prepared for the College of Physicians and Surgeons of British Columbia, November, 1992. Discipline hearings into doctors' conduct are now open to the public in B.C., Alberta, Saskatchewan, Nova Scotia and Ontario: "Hearings on doctor's conduct to be open to public review," *Vancouver Sun*, Feb. 9, 1995 A4.

In every case where concerns about stakeholder representation in peer review procedures have been raised, the solutions proposed or adopted are aimed at increasing accountability to the public and adhere to the following policies:

- to make the process more public
- to enhance the independence of the reviewing body
- to reduce concerns over insularity, collegiality and partiality by dividing the reviewing body into different committees and officers with different responsibilities, including more members of the public in the process, and defining a formal procedure to follow.

*See further, Manitoba Law Reform Commission, Regulating Professions and Occupations*, (Report #84, 1994).



### 6.3 Safeguards Where a Conflict Must be Tolerated

6.3.1 A number of themes emerged from the comments received on the CP on the stakeholder representation issue. For some, the CP seems to have served to draw attention to questions often overlooked by many societies. For others this is an area marked by emerging sensitivities and doubts. Different aspects of stakeholder representation have triggered expressions of public concern. Sometimes it is the presence of stakeholders on the board that attracts attention. This was the case, *e.g.*, when the Racing Commission decided that the racing industry must have representatives on the Commission. In other cases, public complaints have focused on the absence of stakeholder participation in important decisions. For the most part, there is agreement that stakeholder representation is normally an important component of a properly constituted society, if it is to fulfil its mandate.

6.3.2 Less clear are the conflicts of interest rules that should apply to the special cases posed by stakeholder representatives, although there is little doubt that special rules are needed. It is necessary, consequently, (a) to identify rules or principles by which acceptable forms of stakeholder representation can be distinguished from unacceptable self-dealing, and (b) where a board has stakeholder representatives, for consideration to be given to whether special rules are necessary. Special rules would serve one of at least three purposes: (a) to protect the agency (and the public) by ensuring that its mandate is fulfilled, (b) to protect the stakeholder representative director from unwarranted criticism, and (c) to reassure the public that such conflicts of interest that exist are not operating to the detriment of the society and the public.

6.3.3 Not every agency must worry about the last objective of reassuring the public. This factor only arises where the agency carries out a public responsibility or is funded by public money. Directors of privately funded societies, in contrast, must reassure their membership.

6.3.4 The preceding discussion has responded in part to the four basic questions about stakeholder representation that arose during consultation. To recapitulate, they were:

1. should stakeholder representation be allowed?
2. do the LRC suggestions allow for stakeholder representation?
3. what further steps should a board take to safeguard against conflicts of interest where it has stakeholder representation?
4. are there any rules whereby a director, and a board, can determine when the conflict of interest comes too close to allow the director to participate?

6.3.5 The first two of these questions have been answered (yes and yes). This section examines the remaining two questions.

6.3.6 Judging from the comments on the CP, a kind of community consensus may be emerging that might be summarized as follows:

- stakeholder representation is not only acceptable, it is frequently seen as an important, if not essential component of a properly structured board.
- rules or principles must be identified for distinguishing between acceptable stakeholder representation and unacceptable self-dealing.

- few are troubled by the idea that representatives from groups affected by board decisions should be represented on the board, provided they have no special financial stake.
- even those having a financial stake in board deliberations may sit as directors, provided the financial interest is no different in kind from that of all persons affected by board decisions, or of persons in identifiable groups of which the director is a member.
- stakeholder representation is usually unacceptable where the stakeholder may derive a personal, financial or competitive advantage beyond the norm.
- even where the director has a special interest, in the sense that a decision can prefer the individual director's interests over those of others, tolerating the conflict may be defensible where there is a clear need for stakeholder representation and the class from which representatives are available is restricted.

6.3.7 As the Report records, we remain convinced that new legislation must accept and provide for stakeholder representation. Whether in a particular case stakeholder representation is necessary is a question of fact that society members will have to weigh carefully.

6.3.8 Restating the above in terms of when special procedures or safeguards are necessary, these are some of the basic principles that we think apply:<sup>8</sup>

- where all members of a board are stakeholder representatives who make decisions that
  - (a) affect themselves only to the extent that they are part of a group<sup>9</sup> and
  - (b) do not prefer their personal financial interests over those of other members of the group

there is no need to provide special rules to deal with conflicts of interest concerns.<sup>10</sup>

- where all members of a board are stakeholder representatives, but they represent groups whose interests may conflict, steps must be taken to ensure that a proper balance of viewpoints is present on the board.
- special issues or concerns arise where a stakeholder represents a commercial interest.

## 6.4 Systems and Safeguards

6.4.1 Some who commented on the CP agreed that special rules were needed when a board has stakeholder representatives. Others thought the director's duty of loyalty to the society provided all the protection necessary. In contrast, at least one correspondent argued that the reason stakeholder representatives are placed on boards is to look after the interests of their constituents. The law on these

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8. The stakeholder representative category really consists of three different, but related, groups of relationships:

(a) the "special qualifications group:" directors who have special qualifications or experience. The concern here is more often whether the director can remain impartial, or will be biased because of those special qualifications.

(b) the "clients group:" directors who are also clients, or who represent clients, served by the society. There is an obvious conflict of interest, but it is usually a beneficial one, and

(c) the "special interests group:" directors who represent groups having an interest in the work of the society. Groups having an interest may be: organizations involved in related activities, funding bodies and government.

9. *Columbia Basin Trust Act*, S.B.C. 1995 c. 49, *e.g.*, states that a director of the Columbia Basin Trust is not in a conflict of interest by reason of a pecuniary interest if "the pecuniary interest is one that the director has in common with the residents of the region generally:" s. 20.

10. The board may still benefit from having non-representative directors with different viewpoints. Non-stakeholders will also perform a valuable monitoring function. They might, formally or informally, assume the role of determining whether a pattern of decisions prefers the interests of a particular group over those of the community generally. If so, it would be possible for them to draw attention to the pattern and invite outside scrutiny by, *e.g.*, government.

points is not free from doubt. As a practical matter, problems frequently arise in the absence of special rules. This section discusses some approaches, rules and procedures that societies might consider adopting for dealing with the situation that arises when a board member has a conflict of interest that must, for some reason, be tolerated. All are imperfect. By definition, the conflict cannot be removed. All of the available methods attempt, instead, to provide balance and reassurance, and to isolate, so far as possible, the conflict of interest. The following sections discuss these approaches:

- Providing rules that define the extent to which a director is a representative
- Providing for balanced representation.
- Providing that part of the board must supervise the other part.
- Finding the expertise in people who do not represent a commercial interest.
- Advanced disclosure ideas.
- Rules for abstaining from a vote.
- Providing rules for special situations.

## 6.5 Providing Rules that Define the Extent to which a Director is a Representative

6.5.1 Ideally, a director who is on the board because of special qualifications, knowledge or perspective should still act in entirely impartial, unbiased ways, although the decisions made by this director might differ from those made by someone who lacks the special qualifications, knowledge or perspective.<sup>11</sup> For example, a wealthy person and a poor person on a board of a group whose objective is to assist the needy might have totally different perspectives on how that should be accomplished, and reach markedly different decisions without in any way attempting to promote a biased viewpoint, personal interests or the interests of any special group. A woman and a man on the board of a group whose objective is to eliminate gender bias from the law might have very different ideas about the nature of the problem and what its solutions might be.<sup>12</sup>

### 6.5.2 Example

**Worker's Compensation Board Governors are selected by government, labour and management. The Governors operate subject to rules that provide that their decisions are being made in a representative capacity.**

6.5.3 The WCB rules are very interesting because they adopt a conflict of interest definition that excludes the idea that representing a nominator is a conflict of interest. The following extract from the Oct. 7, 1991 *Statement of Roles and Responsibilities of the Voting Governors of the Workers' Compensation Board* is instructive:

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11. An exception might be acceptable where

- there are special reasons for adopting a different approach,
- the different structure adopted is understood by everyone else, and
- the society has procedures designed to operate with directors making biased decisions.

But the law is unclear on this point.

12. In *Biddle v. The Queen*, (Mar. 1995, S.C.C.), a person was convicted on charges stemming from two vicious attacks on women. The prosecutor had used challenges to form an all-female jury. One ground of appeal was the possible bias that might be present in a jury constituted in that way, but the S.C.C. ordered a new trial on other grounds. Two of the judges, however, said that juries composed entirely of one sex or the other cannot be regarded as partial and incompetent for that reason. See, further, S. Bindman, "All-female jury OK in attack case," *Vancouver Sun*, Mar. 3, 1995 A7.

### 3. Legislative Role of the Governors

...The Board of Governors is not a typical “corporate board of directors”. Rather, the representative Governors’ primary duty and responsibility is to represent the interests of their constituencies. Representation is a personal obligation and is not transferable.

The Governors are “legislators”. They are policy-makers vested with broad discretion in many areas. The constituencies of the representative Governors are broadly based.

As with any body of “legislators” representing diverse, and often conflicting, interests, the representative Governors may be partisan. Debate among the Governors during meetings may therefore be vigorous. This situation was intended and will be healthy for the workers’ compensation system....

It is the role and duty of each representative Governor to seek to know and to understand the general, broad interests of the constituency he or she is intended to represent. It is also the role and duty of each representative Governor to seek to know and to understand the general, broad interests of other constituencies and individuals upon whom the exercise of the statutory authority of the W.C.B. impacts....

6.5.4 This model--requiring stakeholder representatives to act in biased ways--is uncommon, although it may well be the practical result of having any stakeholder representative on a board. Correctly structured, it might work reasonably well. The characterization of the model as a legislative one is useful. It is not a model we would recommend for most societies. Events during the summer of 1995 revealed that the model did not work well for the WCB.<sup>13</sup>

## 6.6 Providing for Balanced Representation

### 6.6.1 Example

**A society provides funding (“legal aid”) to people who satisfy a means test so they can hire a lawyer. By statute, 7 directors are lawyers appointed by the Law Society. Government appoints 7 directors. An issue arises with respect to restructuring how legal aid is delivered. Board views divide along “party lines.” Law Society appointments advance views held by many lawyers. Government appointees favour the new structure proposed by government.<sup>14</sup> The deadlock is finally broken by in the introduction of legislation that changes the structure of the board.**

6.6.2 Balancing views on a board will address almost any concern that arises from stakeholder representation. But, as the example suggests, situations will arise where the board will split along partisan lines. There is more to balancing board representation than making sure equal numbers of people who hold competing views are present at the table.

6.6.3 The *Miscellaneous Statutes Amendment Act (No. 3), 1994*<sup>15</sup> provides an amended structure for appointments to the Legal Services Society, which might safeguard against future deadlocks. Under the new arrangement government, the Law Society and Community Law Offices/Native Community Law Offices each appoint five members. In this way, the board now consists of representatives of three separate groups, each with an equal numbers of votes.<sup>16</sup>

6.6.4 More stability can be expected from having more viewpoints on the board, but this principle holds true only up to a point. Eventually, too many competing views will create a board so fragmented that it will become impossible to summon a majority position.

13. J. Hunter, D. McNaughton, “WCB board fired after chief quits; Minister claims interests of injured workers ignored as two factions clashed on board,” *Vancouver Sun*, July 11, 1995 A1.

14. Aug. 2, 1994 Vol. 1, Issue 4, CBA (BC Branch) Issues Alert, “Update: Legal Aid.”

15. S.B.C. 1994, c. 51, proclaimed in effect Feb. 3, 1995.

16. The change may not represent a more stable structure or, if it does, it has been suggested that this is because the community law office representatives may be considered indirect nominees of government, possibly producing unbalanced representation and skewing things to provide a majority reflecting a government viewpoint: *see, e.g.*, Criminal Justice Section of the Canadian Bar Association (B.C. Branch) Minutes of a meeting held Oct. 25, 1994.

6.6.5 A view that more and more people seem to now share is that a board is not properly balanced unless it has people on it that notionally represent the public interest. Just as important as directors who have special expertise are directors who may lack special qualifications but are drawn from and represent the views of the community. Many bodies that regulate professions, for example, as well as crown boards and agencies, are now not considered properly composed unless they have some “lay” representation.<sup>17</sup>

## 6.7 Providing that Part of the Board must Supervise the Other Part

### 6.7.1 Example

**Companies operate collective investment schemes. Directors profit from the success of the schemes, not necessarily the security of an investor's investment.**

6.7.2 The most familiar of the collective investment schemes are mutual funds. Questions have been raised in Australia and, more recently, Canada concerning the potential for people involved with mutual funds to find themselves in a conflict of interest.<sup>18</sup> The Australian Law Reform Commission proposed adding new rules to govern directors of companies that operate collective investment funds, such as:<sup>19</sup>

- the law must provide that the directors owe duties to the investors
- the law must provide that directors owe a duty not to profit improperly from their position
- at least half the board members must be non-executive directors who do not play any part in the day-to-day operation of the company
- non-executive directors are under an obligation to supervise executive directors
- a non-executive director must not be, or have been during the previous three years, an employee or executive officer of the scheme operator or of an associate of the operator
- non-executive directors must not hold shares in the operator or an associate of the operator
- the law should provide that it is an offence for a company that runs a collective investment scheme to operate without the required number of non-executive directors.

6.7.3 This approach is consistent with the views that are emerging in recent re-thinking about principles of corporate governance.<sup>20</sup> The approach recognizes that at least some members of the board will be in a conflict of interest (stemming from a personal financial interest in the activities of the company) and deals with the problem by creating a supervisory role for part of the board. These supervisors are subject to rules aimed at maintaining their impartiality.

## 6.8 Finding the Expertise in People who do not Represent Commercial Interests

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17. In Report #84, *Regulating Professions and Occupations*, (1994) the Manitoba Law Reform Commission recommended that at least one-third of a self-governing council should be composed of public representatives (Recommendation 51) and that public representatives should have the express role of acting as advocates for the public interest (Recommendation 53).

18. See Glorianne Stromberg, *Regulatory Strategies for the Mid-90's: Recommendations for Regulating Investment Funds in Canada* (January 1995) prepared for the Canadian Securities Administrators; Editorial, “A mutual-fund warning,” *Vancouver Sun*, Feb. 11, 1995 A18; I. Jack, “Caution urged in selecting mutuals,” *Vancouver Sun*, Feb. 9, 1995 D5; I. Jack, “Befuddled mutual fund investors deserve to know risks involved, expert claims,” *Vancouver Sun*, Feb. 1, 1995 D4; M. Kane, “Planners press for rules,” *Vancouver Sun*, Apr. 17, 1995 D6.

19. “Collective Investments: Other People's Money,” *Reform* (Dec. 1993), Issue No. 66, p. 7 at 8-9.

20. See, e.g. the “Cadbury Report,” Report of the Committee on Financial Aspects of Corporate Governance (U.K., Dec. 1992).

## 6.8.1 Example

**The life insurance industry protects policy holders through a privately funded scheme. The scheme is run by the board of directors of Canadian Life and Health Insurance Compensation Corp. (“CompCorp”). CompCorp protects deposits of up to \$60,000 and life insurance policies up to \$200,000. Board members are executives from life insurance companies. They have the necessary expertise to make appropriate decisions. But the directors may be in a conflict of interest because, while the public may benefit by sustaining a life insurance company, individual directors (and the companies they work for) may benefit from seeing a rival fail.<sup>21</sup>**

6.8.2 One option for retaining the necessary expertise while minimizing the exposure arising from having people on the board who are in a conflict of interest is to appoint directors who are no longer members of financial institutions. The Canada Deposit Insurance Corp., which runs a similar program to protect bank and trust company depositors, adopts this approach.<sup>22</sup>

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21. B. McKenna, “Conflict seen in insurers’ bailout plan,” *Globe and Mail*, June 17, 1994 B3. See also Report of the Standing Senate Committee on Banking, Trade and Commerce, *Regulation and Consumer Protection in the Federally-Regulated Financial Services Industry: Striking a Balance* (Nov. 1994).

22. Other approaches for isolating or minimizing the conflict: (a) confine CompCorp’s mandate to interceding only at the point where the company is going to go under (this would make sure the focus of the program is on protecting depositors, not life insurance companies). Apparently, the board (and the life insurance industry) views CompCorp’s mandate in this way: McKenna, *ibid.*; and (b) require some non-industry board members. CompCorp already does this. CompCorp’s board has 14 members. 12 of them are voting members. Five of the voting members are from outside the industry.

## 6.9 Advanced Disclosure Ideas

6.9.1 As mentioned earlier, disclosure, like other techniques for controlling conflicts of interest, is not aimed at removing the conflict. The theory is that people will act ethically when business is conducted openly.

6.9.2 We earlier concluded that the current approach of the law, which depends entirely upon disclosure to control a conflict of interest, does not satisfactorily protect a society or the public from being prejudiced by director self-dealing. But where it is determined that a conflict must be tolerated, such as one that arises because of the need to have stakeholder representatives on the board, disclosure techniques can provide many safeguards for controlling the conflict of interest.

6.9.3 In addition to disclosing to the board, the society might adopt rules which require a director to keep other interested parties fully informed about conflicts of interest. The rules could require formal methods of disclosing to members of the society or the society's clients and funders, or members of the public.

6.9.4 Other, more sophisticated techniques for disclosure are based on the same theory that affairs conducted in sunlight are bound to be above board. Societies might consider methods of conducting business in more openly public ways. Where there is the appearance of a conflict, a board, for example, might take special care in setting out the reasons in support of particular decisions. The society might hold public forums, to explain policies and actions, or solicit public input and comments on society work. Some procedures might be given an enhanced profile, or conducted publicly (such as awarding contracts, or disciplining members). While none of these advanced disclosure techniques can provide a complete answer, all of them, to a greater or lesser extent, will reinforce public trust and confidence in the society and its work.

## 6.10 Rules for Abstaining

6.10.1 The current law requires a director to disclose a conflict of interest to the board, and then abstain from voting on whether a transaction affected by the conflict should be approved by the board. Abstaining, in our view, is inconsistent with the director's duties to the society. The director is expected to take part in board deliberations. For this reason, a director should not seek to participate in transactions with a society where the director is also charged with advancing the best interests of the society.

6.10.2 The situation that arises when the director has voluntarily created a conflict of interest is different from a situation where a director is on the board for reasons where, as with stakeholder representatives, it is generally acknowledged that conflicts will arise. Where the director has not self-selected the conflict, then abstaining makes eminent sense,<sup>23</sup> unless the conflicts arise too often for the director to adequately represent the society and look after its interests. There is an obvious trade-off here, as with any of the other techniques for confining a conflict that arises from stakeholder representation.

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23. If, in fact, it is necessary at all for the director to abstain. As discussed earlier, a conflict that arises solely because the director is a stakeholder should not disqualify the director from participating in decisions where it is considered vital for stakeholders to have a voice and vote.

## 6.11 Providing Rules for Special Situations

6.11.1 This section sets out a brief overview of some of the rules and approaches that have been adopted to deal with special conflicts situations:

- *Tendering*: agencies that award large contracts should have tendering rules (a) to reduce patronage opportunities, (b) ensure the agency receives the best deal and (c) give members of the public equal opportunity to bid on contracts.<sup>24</sup>
- *Employing a former director*: agencies that hire staff should have rules about whether former directors can accept contracts with the organization and, if so, whether some period (measured, perhaps, in years) must pass before a former director is eligible for consideration. If such a rule is adopted, it is also useful to provide that the board can make exceptions to it in special cases where that would be advantageous to the agency.
- *Developing policies in advance*: many common problems can be avoided by adopting rules and policies to deal with them, such as processing expense claims,<sup>25</sup> and dealing with incentive programs that reward directors personally for using society funds in particular ways, such as “air miles.”<sup>26</sup>
- *Committees*: committees can be used in several ways. Some tasks which would place a director in a conflict of interest can be assigned to an independent committee whose members have no conflicting interests. Or a committee can be formed to provide advice that might offset the appearance of a conflict or bias, or provide perspectives not represented on the board. Or an independent committee can make recommendations that restrict the choices available to the board, thus limiting exposure to conflicting interests.<sup>27</sup> Such a committee is under consideration, for example, to select candidates for the Immigration and Refugee Board, to counter criticisms<sup>28</sup> about patronage appointments made in the past.<sup>29</sup> Similarly, the Canada Council relies upon paid independent jurors to assess grant applications.<sup>30</sup>
- *Independent chair*: agencies might consider a requirement for an independent chair. On boards where partisan representation is required, it often makes sense to require an independent chair because the chair may be required to rule, for example, on various procedural issues that arise.<sup>31</sup>

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24. The provincial Treasury Board has, *e.g.*, adopted a general management operating policy. The policy has been in place since 1987. It states: “Contracts with a total potential cost greater than \$50,000 should either be advertised in a manner that will ensure a reasonable number of qualified contractors have the opportunity to prepare and present bids or tenders should be requested from a bidders list.” The guidelines, however, also provide that in appropriate circumstances, such as where there is a need to proceed quickly, contracts below \$100,000 can be awarded without tendering: J. Hunter, “Tendering process violated, critic says,” *Vancouver Sun*, Mar. 4, 1995 A2. Flexibility is an important feature, provided it is not used to violate the spirit of the tendering rules. Vancouver Council has also endorsed the policy of inviting public proposals on larger contracts: F. Bula, “Council vetoes suggestion of paying developer \$260,000,” *Vancouver Sun*, May 31, 1995 B5.

25. *E.g.*, by developing a schedule of permitted expenses (and expense limits) or adopting a practice such as requiring any director's expense claim to be approved by two other directors. In some cases, the board can consider whether some kinds of expenses, such as the costs are childcare, are properly reimbursable before they are incurred.

26. The provincial government, *e.g.*, has adopted a policy forbidding civil servants from participating in incentive plans that provide bonuses for travel and accommodation in the course of government business: *Standards of Conduct for Public Service Employees* Q.P. isbn 0772671249. Gifts, prizes and awards must be refused or, if possible, turned over to government or otherwise used to offset government costs.

27. D. Young, *Casebook of Management for Nonprofit Organizations: Entrepreneurship and Organizational Change in the Human Services* (1985) 37 (“...the device of an advisory committee, separate from the board, is of managerial interest; that committee served as a means to engage the participatory advice and support of key practitioners (educators, judges and so on) who were potential referrers of clients, without posing conflict of interest problems.”)

28. *E.g.*, J. Bryden, “Manning demands probe into influence peddling,” *Vancouver Sun*, Nov. 17, 1994 A13

29. C. Schmitz, “Marchi favours vetting of IRB candidates by non-partisan board,” *Lawyer's Weekly*, Nov. 4, 1994 42.

30. Editorial, “A new culture at the Canada Council,” *Globe and Mail*, Mar. 15, 1995 A22.

31. Similar issues arose when selecting a new Lieutenant Governor for British Columbia. Consideration of one candidate, a well known and well respected former member of a municipal council, was criticized because of close ties to the leader of the official opposition party, on the ground that those ties might threaten the necessary neutrality of the office: V. Palmer, “Campbell adviser would be poor successor to Lam,” *Sun*, Feb. 9, 1995 A16.



- *Isolating the conflict:* some steps are available by which a conflict of interest can be isolated. Agencies might consider formally adopting one or more of the following techniques for specific issues that arise: (a) chinese walls (adopting rules and procedures to establish information exchange barriers within the organization, isolating a part of the organization from the conflict), (b) cones of silence (rather than separating departments, a cone of silence establishes an information barrier around one individual or subject), (c) setting out rules regarding the participation of the director in the society or in the activities giving rise to the conflict (or regarding participation in the outside activities that give rise to the conflict) (d) setting out rules regarding how confidentiality issues should be dealt with. Isolation techniques can be applied to the director's participation on the board or in the society, or to the director's participation in the endeavour that gives rise to the conflict. Where, *e.g.*, the director is involved with a company that will be tendering on a particular contract, and the director's participation in the society is deemed essential, then either (a) the director's involvement in identifying the terms of the tender and awarding the contract could be limited, or the (b) the director's involvement in the formation of the tender bid by the company could be restricted.
  
- *Education and information:* once an agency adopts rules on particular issues, it should also regularly remind members and directors about the rules, perhaps on an annual basis. It also makes sense to develop a written policy explaining to directors the duty of loyalty they owe the society, and penalties for breaching it.<sup>32</sup>

## 6.12 Summary

6.12.1 A number of systems can be put in place by boards that have stakeholder representation. In virtually every instance, the system provides an imperfect safeguard. The importance of making sure relevant expertise or special perspectives are available for board decisions, however, requires tolerating the conflict. Judging from the number of calls we received that touched on this issue, this is an area in which in the future we can expect to see new ideas developed and tested for dealing with the problems that arise over stakeholder representation.

6.12.2 The bottom line for societies is that they must appreciate the importance of recognizing when stakeholder representatives are a necessary or validating feature for the board. Where they are, the conflict arising from their participation must be tolerated, but the society must develop rules and safeguarding procedures for (a) identifying boundaries (*i.e.*, circumstances when the conflict cannot be tolerated) (b) confining the conflict and (c) reassuring the public and maintaining public confidence in the society and its directors. The last of these goals, maintaining public confidence, is of importance where the society receives public funds, or is otherwise subject to a public obligation by the nature of the duties it is entrusted to fulfil.

### 6.12.3 *A Break-out Rule*

6.12.3.1 How is a society supposed to conduct business where everyone on the board is in a conflict and must absent themselves from the decision?

#### 6.12.3.2 Example

**A society runs trade shows for its members, which are companies all of which run the same kind of business. All of the directors of the society are employees of the members.**

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32. S.L. Ward, *Tort Liability of Nonprofit Governing Boards* (1993) 78, who also suggests that societies should have written policies concerning disclosure (which should be formal and in writing); as to the utility of adopting formal methods of dealing with conflicts, even where the approach does not have official recognition *see, e.g.*, *Choukalos Woodburn McKenzie Maranda Ltd. v. Smith, Lyons, Torrance, Stevenson & Mayer*, [1995] B.C.D. Civ. 2401-02 (B.C.S.C.), where a conflict of interest involving a lawyer representing a client was handled by following draft guidelines that were recommended by the Federation of Law Societies, but not yet officially adopted by the B.C. Law Society.

6.12.3.3 The directors representing the various businesses would all be in a conflict of interest under the existing law. True, any director can disclose the conflict and not take part in decisions where it arises. But, as in the example of the trade shows, there will be circumstances where so many members of the board are disqualified from taking part in the decision that there is no quorum. In practice, societies facing this problem resolve it by ignoring the conflicts rules. A well developed system of rules should recognize this situation and create an exception for it. The situation calls for a break-out rule.

6.12.3.4 Perhaps part of the problem might be addressed by providing in legislation that a person whose conflict of interest arises solely because that person is a representative of a stakeholder may participate in board decisions affecting the representative unless a majority of the board of directors decides otherwise.

### 6.13 Legal Rules Governing Nominee Directors

6.13.1 Stakeholder representatives can arrive on a board in one of three ways.

- there is no requirement for such representation. The membership decides that the person should be on the board by choosing to cast a vote for that person.
- there is a constitutional requirement for (some) members of the board to have particular expertise or credentials. They are still elected. The membership makes its selections from among the candidates who run for the office.
- the director is appointed to the board by a third party. This may be a constitutional requirement, either set out in the society's by-laws or regulating legislation.

The kinds of conflicts of interest issues already discussed may arise in any of these cases, and lend themselves to the same kinds of solutions. But the third category raises legal issues not present in the first two categories.

6.13.2 As a general rule, the duties placed on directors require them to make decisions that protect and advance the society's interests. Even a nominee director who represents a particular group is not relieved of that obligation, unless the constitutional documents of the corporation (for a society, that would be its by-laws) set out different rules.<sup>33</sup> But the legal rules are not well mapped out. Recent cases provide some guidance. They suggest that a nominee director is often in a difficult situation of divided loyalties.

6.13.3 In *PWA Corp. v. Gemini Group*,<sup>34</sup> nominee directors had information concerning the parties who appointed them to the board. They regarded the information as confidential and did not disclose it to the board. This information, however, was pertinent to the interests of the corporation. The trial judge agreed with the corporation's contention that, by failing to disclose, these directors were in breach of the duties they owed the corporation. The Court of Appeal held that the directors' fiduciary obligations did not extend to disclosing all aspects of what was essentially confidential information relating to the nominating entities, but nevertheless held that the directors were in breach of fiduciary duties they owed their corporation.

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33. See, e.g., *PWA Corp. v. Gemini Group*, (1993) 8 B.L.R. (2d) 221 (Ont. H.C.), upheld in result (1993) 15 O.R. (3d) 730, leave to appeal refused (1993) 10 B.L.R. 244 (S.C.C.).

34. *Ibid.* This case involves a company, not a society, but the same principles would apply to the directors of a society.

6.13.4 What might be the objective of a person who is entitled to decide who will and who will not sit on the board of a corporation? The nominator might have several objectives in mind, such as to:

- make sure that certain viewpoints are considered by the board when it makes decisions
- make sure that the board has some members who have particular areas of expertise
- have a person who is in a position to report back about the internal management of the corporation
- have a person who is in a position to relay to the board the concerns and interests of the nominator and vote accordingly.

The first two items promote the best interests of the corporation and are unlikely to raise conflicts of interest issues. The last two items protect the interests of the nominator. They represent attempts to establish formal methods of external control over the management of the corporation.

6.13.5 From one perspective, formal links between companies would appear to be not only unobjectionable, but desirable. Suppose a business is conducted by a group of interlocking companies. A parent company's control over subsidiaries will allow the business to be conducted more efficiently.

6.13.6 Even where formal arrangements are not in place, boards will usually pay close attention to the concerns of third parties, such as creditors and shareholders. For practical reasons, these people will often be consulted about major decisions.<sup>35</sup>

6.13.7 Nominee directors are a good example, but there are other methods by which one organization exerts control over another. *Colettis v. Greek Orthodox Community of E. Vancouver*,<sup>36</sup> for example, involved a society incorporated by a church. The society's by-laws gave the bishop of the church a right to veto directors elected to the society's board. The court held that the right of veto was valid. In *Nicholas v. Soundcraft Electronics Ltd.*<sup>37</sup> a holding company was in financial difficulties. Its board elected to withhold payments owed a subsidiary. The conduct was held to constitute management of the subsidiary by the holding company.<sup>38</sup>

6.13.8 The law in this area is relatively unformed and in the process of development. We are not proposing the enactment of formal rules to deal with these situations. The area may, however, deserve special attention in a separate project.

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35. See also "Bossy Sponsors", *Economist*, Apr. 30, 1994 98 discussing the relationship between museums and sponsors and how it affects decisions made by museum boards.

36. [1994] B.C. D. Civ. 3960 (B.C.S.C.)

37. [1993] B.C.L.C. 360 (Eng. C.A.)

38. See further S. Griffin, "Holding Companies Conducting Affairs of Subsidiaries," (1994) 110 L.Q.R. 28.

### 7.1 Need for an Adjudicator

7.1.1 One group, while agreeing with the objective of providing clearer guidelines, argued that the approach advocated in the CP could not work without an adjudicator:

As presented, the LRC brief and draft legislation negates its own objectives. Clearly the proposed model cannot work without an adjudicator.

Would an adjudicator be needed any more than under the current model? An approach that provides a board with clearer guidelines about what may be authorized may very well present opportunities for differences of opinion to arise, but no more than is currently the case. The proposed model requires the board to decide whether there is a conflict and whether it falls within the categories of acceptable transactions. A board's decision might be challengeable in court if a mistake is made. But that does not mean that every decision must be subject to a ruling by an outside adjudicator. Nor is it likely many decisions will be challenged, for the same reasons that limit court involvement in society business now.

7.1.2 Another group noted the difficulties of seeking legal redress, and raised that as a reason for doubting the utility of any legal change:

It would be useful if the present rules and any future rule changes be made to be administered or enforced by law. Having had some past experience with another nonprofit society, in dealing with violations of the proper rules of conduct, according to those set out under the *Society Act* of British Columbia, and finding that the violations of these rules were unenforceable, or at least all legal representatives contacted backed off, including the police.

At present, it would seem to be a useless undertaking to even bother to change the rules, if there are no legal means to deal with violations, except perhaps through civil court, which would involve putting up a monetary retainer. This would then exclude most members of a non-reporting, or nonprofit society.

7.1.3 Legal process is a cumbersome method of enforcing rights. Some policy issues are considered to be so important that government has shouldered the burden of enforcement to prevent, for example, criminal activity, and to guard against abuses of human rights. These responsibilities are enormously expensive to discharge. We do not believe that a case can be made out that government should be responsible for enforcing director conduct and punishing lapses from accepted standards. Moreover, few would welcome the increased red tape and day-to-day interference in society activities that would naturally flow from requiring government to discharge that responsibility.

### 7.2 Procedural Issues

#### 7.2.1 *Minuting the Exception*

7.2.1.1 The CP suggested that a board authorizing a transaction with a director should be required to record in the minutes the exception relied upon. This would ensure that the board turned its mind to whether or not the transaction was truly valid under the legislation.

7.2.1.2 Those who commented on the issue were opposed to the procedure:

- Minuting of the specific basis for an exception...should be dumped. As a practical matter either it would never be complied with or some pointless boiler-plate would be developed and automatically inserted in the minutes of every directors' meeting.
- My biggest concern is with section 7(4)...I can understand why it is there. You want people to be aware of the conflict of interest and why it is that an exemption is being made. It is a little like calling your shot in pool.

There are real problems with this idea, however, that I think outweigh the benefits. You are requiring that every board be so familiar with the legislation that they can quote it book and verse. I don't think this is reasonable. Not only

that, but they have to interpret the legislation in ways that even a lawyer might find difficult. In what cases does 5(b)(iii) hold, for example? When is a transaction “fair” and/or “reasonable”? Under what circumstances does 5(c)(iii) hold?

And what are the ramifications of not marking the right exemption? Could the directors be sued because they put down exemption d and it was really exemption f that should have been cited? In that case, each decision should be marked as having ALL exemptions apply, just to be safe. Where is the advantage in that?

If Societies are to live up to Section 5(4) as written, I believe that for practical purposes it requires that each board have a lawyer. Clearly a nonsensical requirement.

7.2.1.3 Both commentators seem to proceed on the premise that boards will, as a matter of course, be authorizing transactions with directors. But the suggested reforms are based on the idea that new legislation will allow few transactions to be authorized. Even those transactions for which an exemption can be found should ordinarily be refused. Moreover, typically it will be the director interested in the transaction who must identify the appropriate exemption and carry the burden of convincing the board that it applies.

7.2.1.4 The CP suggested that where a board authorizes a transaction that is not valid under the legislation, everyone involved in the decision should be protected provided they are acting in good faith. But they had better be acting in good faith.

7.2.1.5 Suppose a board bends the rules a bit. It knows that the transaction cannot be authorized, but goes ahead with it anyway. At the very worst, the position is no more hazardous than under the current law where undoubtedly such a board would have proceeded with little worry about the propriety of the transaction. At least under the proposed model, the board must face the fact that the transaction is dubious. Much will have been achieved if boards become more sensitive to circumstances that actually give rise to a conflict of interest.

7.2.1.6 Will boards adopt boiler plate to try and cover all bases? The whole point is that the transaction with a director should be exceptional. A board that adopts meaningless boiler plate will be in breach of specific statutory duties, and general fiduciary duties, owed to the society. A board should feel very uncomfortable about authorizing a transaction touched by a conflict of interest. A boiler plate clause in these cases will provide no shield. Its use may possibly provide evidence of a dereliction of duty.

## 7.2.2 *After-the-Fact Conflicts*

7.2.2.1 Sometimes the conflict of interest will not arise until after the transaction is approved.

### 7.2.2.2 **Example**

**The society enters into a long term contract with a public relations firm. Director B sees that the firm is a good financial enterprise and buys a substantial interest in it.**

Should a director's subsequent involvement threaten the contract with the society? Can the contract be renewed?

7.2.2.3 The CP discussed these issues and noted the difficulty of drafting rules to deal with them. Appropriate responses will really turn on the circumstances. In these cases, the society membership plays a role. The membership may be asked to ratify an after-the-fact conflict. Similarly, the court may be asked to provide a remedy, but will be unlikely to intervene with respect to a contract where the conflict arose innocently. If there is evidence of planning to evade the conflicts rules, the membership may decline to ratify or a court may make an appropriate order, such as setting aside the contract.

7.2.2.4 Only one group commented on whether special rules were necessary to deal with these problems. This group agreed with our conclusions against special rules to deal with conflicts that arise after the fact, observing that membership ratification and court review should suffice.

### 7.3 Advisor

#### 7.3.1 *Overview*

7.3.1.1 Many of the calls we received after publishing the CP were from people involved in societies who wanted advice about conflicts of interest. They wanted to know whether particular scenarios raised conflicts of interest and, if so, how to deal with them. It became clear very early on that people in the nonprofit sector do not have adequate sources of information or advice on many legal issues, including conflicts of interest, that frequently arise.

#### 7.3.1.2 The CP invited comments on the issue:

12. It is not proposed that legislation establish an office that would provide societies with rulings on whether particular matters raise conflicts of interest and, if so, how to handle them. We would particularly welcome comment, however, on whether an adviser would be useful and should be provided for in new legislation.

While there was a great deal of evidence of a need for an advisor, not all of the comments we received favoured such an office.

#### 7.3.2 *Those in Favour*

##### 7.3.2.1 Examples of comments favouring an advisor:

- We found that the use of examples was helpful to the lay person in understanding the potential conflicts that can arise, but suggest there be some resource to which a society can refer.
- I further agree that an advisor would be very useful and should be provided for in new legislation. I know that had one existed, I certainly would have consulted with that person on more than a few occasions during this past year.
- On the question of whether an advisor would be useful, in my opinion, it would be very helpful to review a potential conflict of interest situation with an independent person with experience in this area.

7.3.2.2 Many who saw the utility of an advisor were sensitive to other issues. They were concerned, for example, about the cost of financing such an office. They did not want to add to government bureaucracy. There was also some apprehension that an adviser might interfere in the internal affairs of societies.

#### 7.3.3 *Those Against*

- We are not convinced that the legislation should create a “Conflicts Commissioner”. We think that the new legislation (and Conduct Guidelines) will provide the necessary guidance to societies and their legal advisors. It may be that if the scope of the legislation is later extended to other bodies, such a source of advice and advance rulings, as well as a mechanism for investigative purposes, will become appropriate.
- By the way, I should make a comment about section 12, since you ask for comment on that subject in particular. I believe that your guiding principle in constructing this report should be to keep the legislation as straightforward as possible. Boards are made up of all kinds of volunteers, and there is a limit to the number of hoops you can expect them to jump through. If you set up conflict of interest regulations so complex that you need an office to provide rulings, you have failed in your task.
- I do not believe that it would be beneficial to the public to create an office of an Official Advisor similar to the Conflicts Commissioner. To do so simply invites more government into our lives and I would think that the concept of Official Advisor as you described could easily be handled by the particular society's legal counsel.

### 7.3.4 *Functions An Advisor Might Perform*

7.3.4.1 Judging from the comments, not everyone had the same idea in mind about what an advisor would do. One person, for example, argues against the need for a person whose job it is to make rulings. Others vote in favour of a person who will provide information and advice. What duties might be assigned to an advisor? Here are some functions an advisor might carry out:

- serve as an independent person to discuss troubling matters that arise, and provide non-binding advice
- formally inquire into particular matters that arise, perhaps on the request of a board, a director, member of the society or, even, a funding body
- act as an appellate authority and rule on whether a board properly authorized (or refused to authorize) a particular transaction
- assist and advise societies in developing specialized conflicts rules designed for their specific needs and activities
- provide advice on systems that might be adopted in cases where conflicts of interest must be tolerated
- provide training for new directors, or conduct seminars for board members that wish to understand the kinds of duties they owe their societies
- propose changes to the statutory guidelines to (a) take into account particular issues that may not already be addressed, or (b) provide new categories of allowable transactions
- act as an ombudsperson for members of the public concerned about the operation of particular societies
- provide information about complaints lodged in respect of societies, to consumers interested in joining, supporting or contributing to a society
- provide mediation or arbitration services when disputes arise between directors, or the membership challenges board decisions, or a board is deadlocked.
- rule on whether particular bodies may be exempted from the legislation.<sup>1</sup>

The range of possible services provided by an advisor suggests that a list like this in the CP might have helped focus comments.

7.3.4.2 We believe much good would follow from establishing a small office to provide advice about conflicts matters. While adopting clear rules should help societies determine whether or not a particular transaction is touched by a conflict of interest, there will still be very difficult questions about ethical conduct.<sup>2</sup>

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1. The CP suggested this function should be entrusted to cabinet but, upon reflection, it seems to us that so empowering a conflicts advisor would be an efficient and economical approach. Cabinet would retain as its exclusive jurisdiction the responsibility of deciding whether to bring within the ambit of the legislation agencies that are not societies but that should be subject to the same kinds of conflicts rules that apply to societies.

2. Notwithstanding the apparent assumption of one correspondent above that it is the rules, not human behaviour, that makes this area complex. Annual Reports of the B.C. Commissioner of Conflicts of Interest show the range of issues raised for his consideration. Similar questions will arise in the context of societies. Legal counsel might be able to perform an advisory role for large societies, but not in small societies. Most of the calls we received were from people

(continued...)

7.3.4.3 All societies, to one extent or another, will face the same kinds of issues. The current requirement for each society to work out its own ethical guidelines is inefficient. Many of the calls we received raised truly difficult conflicts of interest issues for which there are no ready answers. A conflicts officer would very quickly develop expertise, through which, one would expect, uniform standards would emerge. This strikes us as an efficient approach for providing the assistance overworked volunteers need.

7.3.4.4 We are sensitive to the concerns about the expense of a conflicts advisor. But when compared with the amount of public funds invested in nonprofit activities,<sup>3</sup> the expense of a conflicts advisor would appear to be nominal. We believe that this is something that should be done, at the very least, on a trial basis. The mandate of the office could be described fairly generally, to allow the conflicts advisor to perform many functions, but the task which should be singled out as the most important is to provide advice about conflicts of interest.

7.3.4.5 The identity of the holder of the office would be critical. In this respect, the high regard held for British Columbia's Commissioner of Conflicts, the Hon. E.N. (Ted) Hughes, is encouraging. One option would be to explore the idea with Mr. Hughes as to whether his mandate could be suitably expanded to include societies. It strikes us that the expertise that reposes in this office would readily lend itself to resolving the similar issues arising with respect to societies. We recognize, however, that because of the magnitude of these new duties, the Conflicts Commissioner would not be able to carry them out without expanding the resources allocated to the office.

## 7.4 The Draft Legislation

### 7.4.1 *Introduction*

7.4.1.1 A number of correspondents offered detailed comments about the drafting of the legislation. These comments are addressed in this section.

### 7.4.2 *Defining "Conflict of Interest"*

7.4.2.1 The CP set out draft legislation based on the suggestions for changing the law. One might expect that the key to drafting legislation on conflicts of interest would be a definition of the concept. A decision was made, however, to avoid using the term at all. The phrase "conflict of interest" is in common use. It is ambiguous and carries with it a great deal of baggage in the form of pre-conceived notions. No matter how tight the definition set out in legislation, there would be the danger that people would simply assume they knew what was, and what was not, a conflict of interest. For this reason, the draft legislation spoke of "standards of conduct" and proceeded on the premise that most transactions in which a director had any personal interest should be avoided.

7.4.2.2 Not everyone agreed with this approach. One correspondent suggested three reasons why legislation must contain a definition of "conflict of interest:" (a) to minimize the chances of litigation; (b) to avoid incurring costs for legal services and court proceedings; and (c) to prevent premiums for director's liability insurance from increasing:

There should be a definition of a conflict of interest. The risk of litigation over whether a real world situation is offside under the proposed legislation is simply too great. Who would pay the legal costs of a volunteer caught up in such an argument? Existing directors' liability insurance provides little comfort, and I suspect costs of such coverage would escalate under the proposed legislation.

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2. (...continued)  
involved with small societies who felt over their heads having to deal with complex ethical and legal issues that arise under the current law in their volunteer activities.

3. In B.C., e.g., grants in amounts exceeding \$10,000 made in 1993 totalled over \$2 billion.



7.4.2.3 Legislation seldom is able to provide the kind of certainty desired by this commentator. We were, as a matter of fact, criticized by others for trying to be too concrete:<sup>4</sup>

Another problem I have...is the manner in which specific exceptions are identified rather than broad principles that govern exceptions. When you get specific, there is a definite danger that you will miss some situations that should have been covered....

Here is an instance of what I am talking about. Is it not enough to provide the general principle that any transaction from which a director does not benefit directly or indirectly is not a conflict? Why then mention a loan guaranteed by a director? Or an unconditional gift?

### 7.4.3 *Related Person*

7.4.3.1 Surprisingly few people addressed the problems that arise when the conflict is due to a relationship between the director and a third party, although this category of conflicts must frequently pose difficult questions for people in societies.

7.4.3.2 For some, of course, this area was singled out as being the most troublesome. A First Nation society, for example, wrote observing that extended family situations were a recurring source of problems in society activities. A number of callers asked questions about situations that involved a director and people related to the director. One caller, for example, was concerned about problems that arise when there is more than one director from the same family. Here are some examples drawn from calls and letters we received:

#### 7.4.3.3 **Example**

- **A director must decide whether society employees get bonuses. The director has a personal relationship with one of the society employees.**

Problems inevitably arise where a relationship exists between the director and a person involved with the society's work whom the director is required to manage.<sup>5</sup>

#### 7.4.3.4 **Example**

- **A society has commercial dealings with a business run by a member who is related to a director.**

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4. This correspondent questioned the exceptions suggested for gifts and loans. The gift issue is addressed elsewhere and the point is well taken. It was an unnecessary addition. The exceptions for loans, however, and other transactions of long standing acceptance, were included to make sure the argument could not be raised that they were no longer available because they had not been specifically carried forward. Most people would agree that setting out some specific exceptions will avoid unnecessary arguments. The gift situation, however, if truly unconditional, could not possibly raise a profit motive and therefore adding it led to some confusion.

5. A related category of problems arises when directors on a board are related, but these relationships raise less a problem of conflict of interest, than of corporate governance:

#### **Example**

- **A society has a 5 member board with three directors from the same family. On most issues, the family members form a united front.**

#### **Example**

- **Two directors of a society are married to each other.**

Neither example, in itself, raises a conflict of interest. But both examples have within them the potential for creating problems. *E.g.*, a conflict directly affecting one director will usually affect related directors because they would be indirectly interested in the matter by reason of their relationship. Disqualifying family members from taking part in a particular decision because of a conflict of interest might leave the board without a quorum.

Other problems can also be expected to arise from having related directors on a board. Board members, *e.g.*, are expected to scrutinize each other's behaviour, which is made more difficult if there are relationships among some of them, particularly one of marriage. Many societies require, *e.g.*, two signing authorities to issue cheques in the name of the society. This procedure is based on the idea that directors are acting independently, but that is not necessarily the case where they are related.

## 7.4.3.5 Example

- **A society has commercial dealings with a member who is a close friend of a director. The friendship arose through participating in society activities.**

7.4.3.6 What kinds of relationships give rise to an indirect conflict of interest? The last two examples help demonstrate the problem. In the first, the relationship is probably sufficiently close to place the director in a conflict of interest. It makes no difference if the society is dealing with a relation of the director's, or a business enterprise run by the relation.

7.4.3.7 The second example is more difficult. It is natural to favour the interests of friends. A cautious director might well accept the idea that there is a potential conflict of interest or the appearance of one and behave accordingly. But it would also be difficult to fault a director who maintains that there is no conflict of interest in this situation.<sup>6</sup>

7.4.3.8 People might disagree depending on the closeness of the friendship, the amount of money involved in the transaction, and whether suitable alternative arrangements might have been made. In the final analysis, a director who makes a sensible business decision will probably not be faulted. One who participates in a less defensible decision will find concerns raised about real or apparent conflicts of interest.

7.4.3.9 As a practical matter, it is difficult to see how any relationship that arises through participating in society activities can be considered as raising a conflict for directors. Such a rule would probably result in board paralysis in most societies. It is an area where caution must be exercised, however. A particularly close relationship that arises in this way might provide a reason to challenge the impartiality of a director and, consequently, the board.

## 7.4.3.10 Example

- **A society has its books audited by a former partner of a director.**<sup>7</sup>

Neither auditor or director are in a conflict of interest, but the former relationship between them may suggest possibilities of bias. The director should not allow such an arrangement and the auditor should not accept the appointment where their former business relationship was fairly recent. It is the importance of the audit that makes this a special case. None of these problems would arise, for example, if the facts were changed to involve the purchase of stationery from a former partner of a director or the business relationship was one that was severed many years before.

## 7.4.3.11 Example

- **Directors required to travel on society activities decide that it is reasonable that they be accompanied by their spouses, and that the society pay for their spouses' expenses.**

Directors are in an obvious conflict of interest when deciding upon financial matters that affect their spouses. Directors should not be deciding, for example, that it is acceptable for a society to pay for the travel expenses of spouses. The arrangement represents at least an indirect benefit and, in many cases,

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6. *E.g.*, the Commissioner of Conflicts of Interest in a decision concerning contracts awarded to NOW Communications Group Inc. (Apr. 17, 1995) concluded that in the absence of private personal gain, a person is not in a conflict of interest. *See also*, Editorial, "When does patronage become a conflict?" *Vancouver Sun*, Apr. 22, 1995 A26.

7. The *Society Act* sets out rules for auditors of reporting societies, and prohibits a person who is in a close relationship to a director from being an auditor: s. 43. This section sets out minimum requirements but a director's duty of loyalty might require higher standards.

a direct benefit to them.<sup>8</sup> When these issues have arisen with respect to public officials, they have provoked much community concern, leading in some cases to reversals in policy.<sup>9</sup>

7.4.3.12 The problem is that the board is the body that is required to decide these kinds of issues. Possibly the best practice in these cases is to involve the membership in deciding on firm guidelines about when, and what kinds of, these expenses are recoverable.

7.4.3.13 Some who commented on the CP were prepared to dismiss concerns about indirect conflicts of interest as an overreaction to the general problem. Most, however, recognized that any one person might arrive at entirely different decisions about a particular issue depending on the degree of personal interest in the issue. Human nature being what it is, some people have little difficulty in finding reasons to justify making decisions that somehow promote personal interests or those of related people. Others react entirely differently to temptation, strenuously avoiding any hint of personal favouritism by making decisions that err against personal interests. But even the prospect of erring on the side against the supposed conflict means that the views are not impartial. It is very difficult to be impartial.

7.4.3.14 On the question about identifying relationships which give rise to an indirect conflict of interest, the CP suggested carrying forward the current law on this point, which simply speaks of conflicts involving a director who is “directly or indirectly interested in a proposed contract or transaction.” This was referred to as a “minimalistic approach.”

7.4.3.15 Two submissions agreed with taking the “minimalistic approach,” although concerns were expressed about the language that should be used to capture it in legislation:

- I think that you are on the right track when you decide on a minimalistic approach on p. 78 of your paper. I think the words “directly or indirectly” are far better than trying to list all the possible events which might cause a default.
- We note that on pp. 77-78 the Consultation Paper states that the *Society Act* addresses the issue of conflicts involving a director who is directly or indirectly interested in a contract. The Paper suggests that this is a minimalistic approach but that this seems to work fairly well. We have examined the proposed legislative change to overcome this minimalistic approach. This is found on p. 103 under the definition of “related person.”

“Related person” is defined to mean a person who has a family connection or business association with director such that

...(b) the relationship might affect, or give the appearance of affecting, the director's ability to act impartially on behalf of the society.

We have some difficulty with this wording. We think that the approach taken under the *Society Act* discussed on pp. 77-8 is preferable.

7.4.3.16 The *Society Act* speaks of conflicts involving a director who is “directly or indirectly interested in a proposed contract or transaction.” The second comment preferred this simple statement over the one set out in the CP. But there is some advantage to incorporating expressly the idea that conflicts can arise by reason of a relationship. The approach is still minimalistic, because it doesn't spell out what relationships will give rise to concern. In each case it will depend on the circumstances.

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8. Cf. Example

- **A director incurs expenses on society activities and submits a claim for reimbursement to the staff of the society for processing.**

The problem here is that without guidelines, a director is personally deciding what are reasonable expenses. As a practical matter, in the absence of firm rules, it is very difficult for a staff member to question a decision made by someone who is, essentially, the employer.

9. J. Taber, “Take along wallet if you take spouse, MPs, senators told,” *Vancouver Sun*, Dec. 7, 1994 A8. The body that decides whether expenses are recoverable by Members of Parliament and by Senators has announced a new policy that spouses who accompany parliamentary partners must pay for their own expenses.

7.4.3.17 Because many people without legal training seem to overlook concerns that arise when a relation may be involved in a transaction with a society, it strikes us as sensible to highlight the point.<sup>10</sup>

#### 7.4.4 *Appearance of a Conflict*

7.4.4.1 The draft legislation and guidelines are concerned not only with conflicts, but the appearance of conflicts. Only one group had trouble with this idea:

We believe that this codification of the trend towards broadening the scope of conflicts of interest to include the appearance of a conflict of interest is unfortunate. This trend has originated in the political arena where it had become common to attempt to justify the making of an unsubstantiated allegation of conflict of interest by claiming that even if there was no actual conflict of interest, the target individual is somehow at fault for allowing an appearance of conflict of interest. "Appearance" is in the eye of the beholder. It is a subjective matter, over which the directors and officers of a society have no control. In our view, avoiding the appearance of a conflict of interest should be left to the good judgment of individuals and the policies of societies. It should not be codified as an obligation.

7.4.4.2 The point is an interesting one but we are not sure we can agree with it. Some conflicts of interest are glaring. Others are not. Our consultation firmly established that different people have different ideas about exactly what the term "conflict of interest" means. An appreciable number, we suspect, would agree with those of our correspondents who told us that there is no conflict without personal profit, overlooking concerns that naturally arise when a personal interest may lead a person to make a biased decision.

7.4.4.3 Much is gained by requiring people to avoid the appearance of a conflict. For one thing, the approach avoids philosophical arguments concerning whether someone is in an actual conflict of interest situation. The discussion in the last section concerning conflicts of interest arising from a relationship show some of the gradations that may exist between (a) not having an indirect interest and (b) having an indirect interest which qualifies as a conflict of interest. Eliminating the idea that appearances of a conflict are matters of concern imports a subjective dimension. A director may decline to disclose a personal interest, deciding there is only the "appearance of a conflict." Often these kinds of questions are very close to call. We believe it is preferable for a board, faced with a decision about whether to allow a transaction, to be responsible for deciding whether there is a conflict of interest in fact, or whether there is only the appearance of one. In many cases, a board will be wise to avoid the appearance of a conflict as sedulously as actual conflicts.

#### 7.4.5 *Disclosing a Conflict of Interest*

7.4.5.1 The draft legislation and guidelines require people to disclose when their personal interests become involved with those of the society. A number of issues were raised in one submission about what must be disclosed, and how this might affect solicitor/client privilege:

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10. See the definition of "related person" in the draft legislation in Volume I. Recent news stories provide examples of actual and apparent conflicts of interest, where a person received or appeared to receive an indirect benefit by conferring benefits to a spouse: e.g., CP, "B.C. hospital hires fired official," *Vancouver Sun*, Feb. 10, 1995 B3 (a Nova Scotia deputy health minister was dismissed when her husband attended a staff meeting at their home and later sent out brochures to hospitals offering private consulting work and suggesting some influence over health care reform); J. Lee, "Conflict charged as jobs go to spouse of bureaucrat," *Vancouver Sun*, Mar. 22, 1995; J. Hunter, "Contracts to deputy minister's spouse probed," *Vancouver Sun*, Mar. 23, 1995 B1 (an investigation was made into government contracts awarded the husband of a deputy minister. The contracts were with another ministry, but funded by the deputy minister's ministry. No conflict was found: J. Lee, "Deputy minister cleared of conflict allegation," *Vancouver Sun*, Apr. 17, 1995). Organizations often adopt policies that restrict employing both spouses, or that restrict social interaction between employees. The avoidance of conflicts of interest is one reason for doing this, but there are others, such as: (a) avoiding sexual harassment issues in the work place; (b) avoiding management problems that arise if (i) one spouse must supervise the other; (ii) spouses have access to sensitive information; (iii) one spouse's position is terminated or one spouse is relocated; (iv) personal disputes interfere with their work: Edmonton Journal, "Taking the heart out of work," *Vancouver Sun*, Feb. 15, 1995 D1; Column One, "What's love got to do with it?" *Vancouver Sun*, Jan. 7, 1995 (both articles discuss fraternization policies adopted by Wal-Mart). The legality of such policies may be tested in *C.N. Weber Limited v. Dooley*, (application for leave to appeal to the S.C.C. filed June 6, 1995) (S.C.C. Bulletin of Proceedings, July 21, 1995). Even if there is not a formal policy restricting such relationships, it is wise for related people to avoid being placed in situations which hold the potential for a conflict of interest.

...the draft legislation provides that a “director who must not participate in a board decision must (a) disclose the reason to the board...” This may in some cases be contrary to solicitor client privilege or other professional obligations of confidentiality....

Similarly, section 1.4 of the Draft Model Conduct Guidelines requires a person to “disclose a conflict of interest in writing to the Board of Directors...” This may interfere with solicitor client privilege.

Also, it is not clear whether this obligation requires disclosure only when an actual conflict of interest has occurred (e.g., a violation of the Conduct Guidelines) or if it requires disclosure where steps have been taken to avoid what otherwise would have been a conflict of interest. For example, where a director absents himself or herself from a discussion and decision in order to avoid a conflict of interest, is it intended that the director should make a written disclosure to the Board?

7.4.5.2 We are certain that there are, and will always be, many questions surrounding the requirement to disclose, in the context of directors and societies, and many other areas where the law imposes such a duty. We are less confident that legislation can set out a formula for determining in advance what degree of interest or involvement raises the duty to disclose. As a general rule of thumb, a director would be wise to disclose any personal interest which becomes involved in society business, limited by concerns over raising truly trivial or irrelevant matters. The reason a director should ordinarily disclose non-trivial conflicts is that even if there is no question of either personal profit or unethical conduct, it would certainly reflect badly on the board if they accidentally authorized something which benefited a director, or appeared to do so, even one who did not take part in the decision.

7.4.5.3 The comment quoted suggests that a director might deal with a conflict of interest by simply not taking part in the decision. It is important to underscore that absenting oneself from a meeting without disclosing the conflict is not an acceptable solution. It provides the director with no protection whatsoever because it does not satisfy the requirements of the *Society Act*.

7.4.5.4 The questions concerning solicitor/client privilege are more difficult. Which is the more important obligation? To protect the client's confidence, or carry out duties owed the society? We doubt whether any circumstance would justify a director breaching solicitor/client privilege. In most cases it will be enough, without breaching confidences, to identify the general nature of the conflict, and that it stems from a relationship with a client. We are opposed, however, to providing some general exception which would exempt a director from disclosing by reason of a solicitor/client privilege. This is not a problem that is exclusive to lawyers. Cases will arise in which directors, whether lawyers or not, will be placed in positions of unresolvable divided loyalties:

#### 7.4.5.5 Example

**The society invites bids from contractors to build a theatre. A director, who is a bank manager, has a client who bids on the contract. The director knows this bidder is in severe financial difficulties and may not be able to complete the contract. If the society pays any portion of the purchase price in advance, it may well be unrecoverable. The client is indebted to the bank, however, and if the client is awarded the contract, the bank's loan may be paid in full.**

What is the director's duty to inform the society?

7.4.5.6 These points were raised by a group which provides funds to people involved in particular classes of litigation. The directors also provide legal services, for pay, to people who are granted funds. This group felt there was no ethical dilemma in this structure, but the concerns raised over solicitor/client privilege underscore the problems faced by a person prepared to assume roles in which there will, inevitably, be a conflict of duty to the society and duty to another, such as a client. Is the answer really to tolerate the conflict, as this group suggests? Would it not be possible to find capable people to act as directors who won't be making decisions which affect their personal, business interests?

## 7.4.6 “Community Expectations”

7.4.6.1 The draft legislation incorporated the idea that some transactions touched by a conflict of interest might nevertheless be authorized by the board of directors. But even in these cases, the draft legislation required a two-part test of fairness to be met. The transaction must be (a) fair from the society's perspective, and (b) in keeping with community expectations about the conduct of the society's activities.

7.4.6.2 The idea is a difficult one to express. Some might argue that the best financial deal for the society must always be “in the public interest” or in accordance with “community expectations.” What we tried to encompass, however, were only partly financial issues. For example, often a public bidding process will be expected if public money is involved. Community expectations are served by awarding contracts in a fair manner, not just to a person prepared to give the society the best deal. Other examples: (a) the community might expect the contract to be awarded to someone in the community as opposed to someone in another community or country; (b) some transactions may involve particular values or viewpoints, and the community expectations might be that the board's decision have the effect of promoting generally accepted values and viewpoints (for example, promoting multi-culturalism or gender equality).

7.4.6.3 Two submissions commented, negatively, on the concept of “community expectations.”

- “Community expectations” are subject to change over time and cannot be legislated. Therefore the vagaries would provide fodder for litigators to argue over without providing any useful guidance to directors facing a decision.
- We foresee difficulty in interpreting and applying the words “community expectations” used in this subsection.

7.4.6.4 We certainly agree that the concept is a difficult one to tie down in legislative language. But observing the difficulty doesn't really advance the task of devising a better formulation. Can the idea be captured in more specific terms? Any other formulation would be just as difficult to interpret and apply. The real issue is whether the factor is one that a board should have to consider. We believe that the larger interests of the community, from which the funds are usually derived for the society's activities, are frequently ignored in board decisions which authorize a transaction notwithstanding a director's conflict of interest. The difficulty in capturing the idea in legislative language does not strike us as being in itself a good reason for saying that a board need not consider the best interests of the community when deciding whether to approve a transaction coloured by a director's conflict of interest.

7.4.6.5 How much danger is there in incorporating such an idea? Other legislation has found it necessary to refer to similar kinds of tests. The *Society Act* itself adopts a test that turns on whether actions are “contrary to the public interest:”

85. (1) Where it appears to the registrar that a society
- (a) exists for an illegal purpose;
  - (b) carried on chiefly as a social club is not conducted in a proper manner or as a bona fide club;
  - (c) within the scope of section 14 is not conducted in a proper manner or is or is likely to become insolvent; or
  - (d) is otherwise acting in a manner contrary to the public interest,

the registrar shall report the facts to the minister, who may appoint a person to investigate the affairs and conduct of the society and to make a written report to him of his findings.

Similar concepts are incorporated in the sections that apply to societies that regulate professions or occupations.<sup>11</sup>

#### 7.4.7 *How Much of a Majority Should Be Required to Approve?*

7.4.7.1 The CP suggested that a transaction could not be authorized with a majority of less than 75 per cent of the directors on the board who are present and entitled to vote at the meeting. One group saw practical difficulties:

...for the board of a small society with a limited number of directors which was required to comply with a 75 percent majority requirement. We thought that this provision was undesirable for that type or size of society.

7.4.7.2 If the board is very small (say 3 people) the rule would require unanimity. Unanimity in these circumstances is not objectionable. True, from the interested director's perspective, unanimity might represent a practical difficulty. If, however, the procedure is truly to protect the interests of the society and the community, then there is nothing objectionable about a requirement which may, in some cases, only be satisfied by unanimity. If one person of a three person board has doubts about the wisdom of allowing the transaction to proceed, then what is the argument in favour of having it proceed? In most, if not all, cases societies will be better served if directors do not personally profit from their activities with the society.

#### 7.4.8 *Guidelines for Authorizing Transactions*

7.4.8.1 The CP spent some time analyzing classes of transactions and identifying those which, even if a director has an interest in them, are acceptable. This was the list of acceptable transactions which a board could decide to authorize:

- transactions which only the director (or a related person or third party) is willing to carry out,
- transactions which manifestly represent benefits to the society so substantial that no other decision than to enter into the transaction makes economic sense, or
- transactions, the financial consequences of which are minimal.

7.4.8.2 One group expressed concern over the application of these subsections because they are open-ended, but did not suggest an alternative approach, or categories of transactions less open-ended which would meet with their approval. Perhaps part of the problem is that these kinds of descriptive categories are not typically made part of legislation. These tests, while useful for a board of directors, would be difficult for a court, for example, to use when determining whether the board acted properly. Since the real goal is to provide the board with guidance, this is another reason for conveying some of these ideas by non-legislative means.

#### 7.4.9 *Who is a Director?*

7.4.9.1 The word “director” is given an extended definition under the *Society Act*. The word is defined as including “a trustee, officer, member of an executive committee and a person occupying any

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11. Part 9.1. See, e.g., ss. 86.2 and 86.5. See *Feldhaus v. Registrar of Companies, A.G. of B.C., and Simon Fraser Student Society*, (1994) 95 B.C.L.R. (2d) 382 (C.A.) (which held that a society acting in accordance with its by-laws is not acting contrary to the public interest). See also *Vickers v. Rondpre*, (1993) 86 B.C.L.R. (2d) 126 (C.A.) and *D. v. National Society for the Prevention of Cruelty to Children*, [1977] 1 All E.R. 589 (H.L.), both of which concern the application of the common law test of public interest as it applies to issues of confidentiality. *Dubuc v. Corp of the District of Saanich*, [1995] B.C.D. Civ. 2984-02 (S.C.) dealt with a test based on the “public interest” as it relates to approving subdivision plans. However, the Supreme Court of Canada held that a test based on the “public interest” was too vague to guide the exercise of judicial discretion in applications for judicial interim release: *R. v. Morales*, [1992] 3 S.C.R. 711.

such position by whatever name called.”<sup>12</sup> The B.C. *Company Act* also adopts an extended definition of “director” to ensure that people do not avoid duties set out under the Act by adopting a different name for the functions they serve.

7.4.9.2 The draft conflicts of interest legislation set out in the CP defined “director” to mean “a director of a society, or a person in a similar position.” The last words, “person in a similar position” were not included to capture influential non-directors. Such people are already encompassed by the reference to a “director of a society.” The concluding words were intended to ensure that the Act could be applied to organizations that were not set up as societies, but that were similar in form, function and management and faced the same kinds of conflicts of interest issues as societies.

7.4.9.3 The question was raised in one submission whether it would be possible to change the legislation to impose special duties on influential non-directors without making them directors. There is no evidence that the extended definition is causing mischief, or placing non-directors in awkward situations. But it is clear enough that the definition poses some practical difficulties. To give one example, the *Society Act* requires a director who is in a conflict of interest to disclose the fact to all other directors. How is that person to determine whether particular people not formally elected to that position, because of the active role they have taken, qualify as directors?

7.4.9.4 The issue is outside of the terms of reference of this project, but it is one that is probably worth considering in the context of a general review of the *Company Act* and the *Society Act*. Other jurisdictions, for example, have found it necessary to provide that people managing companies, whatever their titles, are directors. In the absence of such a provision, experience demonstrates director-less corporations proliferate.<sup>13</sup> But there may be other ways of dealing with the issue, perhaps following the suggestion of our correspondent mentioned above. Another option, which might help a good deal, is to specify certain circumstances where a deemed directorship does not arise. Ontario, for example, adopted exceptions for:

- officers who manage a business under the direction or control of a shareholder, and
- lawyers, accountants and other professionals who take part in management only to provide professional services.<sup>14</sup>

#### 7.4.10 *Voiding Transactions*

7.4.10.1 The *Society Act* currently provides that where the procedure for dealing with a conflict of interest is not followed, a court has various powers to deal with the transaction. This policy was carried forward in the draft legislation suggested in the CP, where the court would be able to:

- (a) prohibit the society from entering the proposed transaction,
- (b) set aside the transaction, or
- (c) make any order that it considers appropriate.

7.4.10.2 One correspondent suggested that the section should incorporate a limitation period on when an application to set aside or vary a transaction can be brought. There actually is a

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12. S.1

13. See, e.g., G. Owen, “Amendment to OBCA would impose deemed directorships,” *Lawyers Weekly*, Sept. 24, 1993 16, commenting on initiatives in Ontario to revise its *Business Corporation Act*.

14. These changes were adopted in response to a brief filed by the Canadian Bar Association-Ontario.



limitation period on an application for any of these orders. The *Limitation Act*<sup>15</sup> provides that the limitation period for applications of this kind is 6 years from the date the right to bring the application first arises.

#### 7.4.11 *Challenging A Board Decision*

7.4.11.1 The draft legislation in the CP provided that a board decision about a conflict of interest was not reviewable, if:

- (a) procedures required for arriving at the decision were observed,
- (b) the board had enough information about the transaction to assess the nature of the interest of a director or a related person in it, and
- (c) the board acted honestly and in good faith.

7.4.11.2 Currently, a board decision is ordinarily final because there is no limitation under the *Society Act* on the ability to authorize a transaction coloured by a conflict of interest. Of course, the transaction could be challenged if the director failed to fully disclose, or if there was a conspiracy among board members.

7.4.11.3 The natural result of placing limits on a board's ability to authorize transactions is that at least some approved transactions will be subject to challenge in court, unless the legislation otherwise provides. The better policy, it was concluded, was to accept any transaction honestly approved by the board (by reference to the three conditions) even if in violation of the Act.

7.4.11.4 One group thought that new legislation should be silent on the point:

...s. 8(7) of the proposed draft legislation...is hardly a privative clause. We do not think that there should be one. We do not think a privative clause would make any significant difference to the potential number of applications to a court under the proposed legislation. We therefore do not favour including a privative clause.

By “privative clause” this group means legislation aimed at restricting a court's ability to review particular decisions.

7.4.11.5 The factors listed in para 7.4.11.1 actually constitute a fairly accurate description of what is implicit under the current conflicts of interest regime. If a board of directors authorizes a transaction under the *Society Act*, but does not act honestly and in good faith, the decision will be open to challenge. The section was included in the draft legislation to comfort members of boards who otherwise might feel at risk every time they were asked to rule on a matter involving a conflict of interest. It would also provide some comfort to the interested director and to third parties involved in the transaction.

7.4.11.6 Should some transactions authorized by a board, acting in good faith, and with full information about the nature of the transaction, be subject to attack because legislation says boards ought not to authorize them? This does not strike us as a desirable result. Something more must be necessary before contractual relationships can be susceptible to being set aside in circumstances where everyone is acting in good faith.

7.4.11.7 Our conclusion is that the point of vulnerability must be established by some evidence that the board was aware the transaction violated the requirements of the legislation. In some cases, it may be that the transaction is so obviously tainted that no board acting reasonably and in good

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15. R.S.B.C. 1979, c. 236.

faith would have endorsed it. In other cases, evidence that the board was not acting in good faith might be derived from the same kinds of indicia that indicate a fraudulent transaction: for example, decisions made with undo speed or in secret or decisions that are supported by backdated memoranda.

7.4.11.8 Some people might assume that the best guide is simply whether the transaction makes sense from a commercial perspective. Often, however, that test would produce misleading answers. The decision that best promotes a nonprofit society's objectives will sometimes bear little resemblance to the kinds of decisions made by for-profit organizations:<sup>16</sup>

The nonprofit board is more varied than the business corporate board. Directors on the nonprofit board may have had no previous financial or business experience, and in some areas such as the arts and humanities, neither may senior inside management. Financial and business experience may not correlate with nonprofit experience. For instance, many nonprofit performing arts organizations lose more money when they perform with a full house than when they are closed. They may have balance sheets that would cause the directors of the business corporation to declare bankruptcy. Many nonprofits are under-represented by counsel. With a few exceptions, guidance may not be available.

7.4.11.9 Even if, as was suggested, the section provides no additional protection over simply leaving the legislation silent on the point, it strikes us that it should be incorporated in the legislation. If nothing more, it will meet the worthwhile objective of setting out the relevant principles for the reassurance of directors and members of societies who have no legal training.

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16. James J. Fishman, "Standards of Conduct for Directors of Nonprofit Corporations," (1987) *Pace Law Rev.* 389, 409.