Organizational and Supervisory Law in the Nonprofit Sector

RONALD HIRSHHORN
DAVID STEVENS

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Foreword

Bookshelves are loaded with studies of the public sector and the market sector. But the nonprofit sector is still an emerging sector, a sector that deserves a lot more attention, for a number of reasons. Governments are shifting the delivery of programs to charitable organizations, social needs are rising in response to dramatic changes in the world of work, in family structure and in government spending. Opinion leaders are beginning to focus attention on the importance of civil society.

At the centre of these transformations is the nonprofit sector – a confusing mixture of formal and informal institutions created to serve the needs of Canadians. This is a sector where Canadians take care of each other, talk to each other, and advocate for their beliefs. It is the sector where hospitals and universities serve their patients and students. It is the sector that includes the clubs that citizens form for their own interests. And as governments change their patterns of delivery, it is a sector that includes very large service organizations like airports and air traffic control.

The confusions about the sector are numerous. What should we call it? Is it the nonprofit sector, the third sector, the social sector, the civil sector? What kind of creature is it with all its diverse components? How big is it? How does it function? How should it be taxed and regulated? Who holds it accountable? What are its prospects? Canadians have to find answers to these questions in the next few years.

This working paper addresses the shortcomings in the existing framework of organizational and supervisory laws applying to the sector. It argues that current laws do not enhance or enable activity in the sector, nor do they provide the clear, stringent fiduciary safeguards needed to build public confidence. The paper is one of three commissioned by CPRN in 1995 on behalf of the Nonprofit Sector Research Initiative of The Kahanoff Foundation. The goal of the CPRN project was to use economic and other expertise to assess the existing knowledge base in the formal academic literature and in scattered data sources. The other two papers deal with the size, scope and characteristics of the sector and with tax incentives for charities. The overview study, published in July 1997, reports on these three papers and a roundtable convened by CPRN in January 1997. Together, the study and the three working papers establish a baseline of what we know and what we do not know. Our object is to set a frame for further research and policy thinking about an emerging sector – a sector that has consequences for every citizen and for the health of Canadian society.

I want to thank The Kahanoff Foundation for initiating this work; Ronald Hirshhorn, the Director of the CPRN project; and the Advisory Committee, which met formally

four times, read numerous drafts, and provided frank comments. And, last but not least, I want to thank the authors – Ronald Hirshhorn and David Stevens – who have provided us with a stringent critique of the current state of the legal framework for the project, as well as some constructive ideas for legal reform.

Judith Maxwell
President

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Organizational and Supervisory Law in the Nonprofit Sector

1 Definitional and Analytical Starting Points

This study examines federal and provincial legislation governing the organization and supervision of nonprofits. Social service charities, religious organizations, advocacy groups, cultural organizations, social clubs and other types of nonprofits fill an important role in satisfying social needs that cannot be met adequately by public sector or for-profit organizations. They may become an even more important institutional alternative in coming years. With the increasing fiscal pressures on governments, and the need for new services to help individuals adjust to the changes wrought by globalization and the information revolution, nonprofits are being called upon to assume an expanded role. Some observers foresee nonprofits becoming a much more important provider of welfare, of health care and of job training, as well as a growing source of employment. Many see them as important vehicles for promoting the civic traditions and fostering the cohesiveness that enriches communities.

Against this background, it is of increased importance that governments establish the necessary legislative infrastructure to support nonprofit activity. There is a need to ensure that we have in place modern and responsive laws that meet the needs of nonprofits for appropriate organizational forms. The purpose of this study is to help determine how governments can meet this requirement. Current federal and provincial policies are examined and specific proposals are put forward to remedy deficiencies in the framework of legislation governing the organization and supervision of nonprofits.

We begin our foray into the world of nonprofit organizational law in this chapter with an examination of some conceptual issues. After describing our use of the term "nonprofit," we look, in general terms, at the role of organizational law. This is followed by an examination of some particular features of nonprofits that affect the application of organizational law to this sector. In developing organizational laws, policymakers are challenged by the diversity of nonprofits and the special accountability issues to which they give rise. In the fourth section of this chapter, there is a discussion of some practical constraints that limit what one might reasonably expect to achieve through organizational law. Based on the preceding discussion, we identify a number of central objectives that should govern the development of organizational and supervisory law for the nonprofit sector. These objectives, which pertain to both the substance and institutional structure of a nonprofit policy regime, are discussed in sections 5 and 6.

1.1 What Are Nonprofits?

Various definitions have been applied to the term "nonprofit." While it is generally understood that the term refers to organizations that operate in that hazy middle ground between the public and market sectors, there is no agreement on what constitutes the most important distinguishing features of nonprofits. In keeping with the terms of reference for this study, we define nonprofits to include all organizations that are subject to a nondistribution constraint and dedicated to an objective other than pursuit of profit. Unlike for-profit enterprises, nonprofits do not have any claimants with a right to appropriate their operating surplus. While in for-profits the goal is to enrich stakeholders, nonprofits exist to satisfy a range of consumer and societal needs.

This definition raises a few points for discussion. First, a diverse array of organizations are subject to a nondistribution constraint. The definition covers "charitable" organizations (including those involved

in health, education and religious activities) as well as public interest and advocacy groups; organizations that provide benefits only to members; and organizations that, aside from their nonprofit requirement, are similar to commercial enterprises. Nonprofits include large organizations, with operations throughout the country and layers of professional staff; and small, community-based organizations with limited revenues and a high dependence on volunteer labour. While many nonprofits rely largely on private sector contributions, others, including universities and hospitals, are so dependent on public financial support that they might be seen to reside on the fringe of the public sector.

Second, by focusing on the nondistribution constraint, we are defining nonprofits on the basis of property rights. In for-profit firms, owners possess three primary rights: to control the firm, to receive the surplus that remains after all expenses have been paid, and to transfer the previous two rights. In nonprofits, property rights are severely attenuated. By virtue of their contributions of time and/or money, stakeholders in nonprofits may gain certain rights of control.[1] But stakeholders do not have any claim to the organization's surplus, and their interest, such as it is, is generally nontransferable.[2] Our definition accepts the legitimacy and significance of these differences in property rights.[3]

1.2 The Role of Organizational Law

Organizational law can facilitate nonprofit activity by making it easier and less costly for individuals to work out satisfactory arrangements. The establishment of any organization involves a complicated set of contractual arrangements. It is difficult and costly to work out a set of agreements that limit the uncertainty faced by stakeholders and reduce the potential for costly conflicts down the road. Organizational laws reduce the transactions costs associated with the development of adequate arrangements. By setting out a framework for the organization and conduct of federally incorporated business, for example, the *Canada Business Corporations Act* obviates the need for a large number of separate agreements between and among shareholders, creditors, directors and others. Corporate legislation provides the parties with contract terms they can adopt "off-the-rack," incorporating the general provisions that knowledgeable individuals themselves would have bargained for if transactions costs were not a constraint.[4]

Governments have long had a responsibility for the establishment of "economic framework" legislation, which encompasses organizational law. The role of government in developing organizational law can be justified from a normative perspective because such laws are in the nature of public goods. Corporate codes and other standard form contracts differ from ordinary goods because they are characterized by "nonexcludability" and "nonrivalry" in consumption. While nonexcludability makes it difficult for private firms to enforce their property rights (e.g., fish in the sea), nonrivalry makes it undesirable to enforce such rights because additional users in no way decrease the benefit derived from the good by the original consumers (e.g., television programs). Therefore, although model organizational codes could, in principle, be developed and sold by private firms, markets would not lead to an efficient outcome.

Given the supportive function of organizational law, the question arises as to whether, and to what extent, such laws need be mandatory. Standard form contracts developed by the government could, in other words, be one option but not the only option available to organizing parties. There is less need for mandatory laws if those charged with developing governance arrangements are under pressure to establish mechanisms that effectively respond to the interests of all parties. In the case of for-profit corporations, it has been argued that such pressures exist because the terms of corporate charters are reflected in the market valuation of the enterprise.[5] Company founders that develop inadequate governance mechanisms will be penalized when they sell their claims in the market, just as they would if they put investors at risk through, for example, poor quality controls or inefficient operating procedures.

Even in the presence of efficient capital markets, mandatory laws may be desirable because of the need to protect investors against unexpected governance changes that may occur after the corporation has been

formed. Concerns arise because, at this later stage, undesirable changes in governance are less likely to impose a cost on the managers or entrepreneurs who initiate the change.[6] The arguments for mandatory laws are stronger where the markets within which governance arrangements are created are subject to various imperfections – i.e., a lack of competition, poorly informed participants, significant impacts on those not involved in the transaction (externalities). These problems require attention, particularly as we extend our focus from publicly-traded corporations to other organizations. In many situations, there is reason for concern that governance arrangements will be worked out without all parties being adequately represented and adequately informed.

In addition to responding to the need for mandatory laws, however, governments can provide a useful service by developing suppletive codes that organizations can adopt at their discretion. The availability of optional clauses can help in the development of adequate governance arrangements, while providing the flexibility to accommodate the differences among nonprofit organizations.

What all this suggests is, first, that standard form contracts offer important potential savings in transactions costs; second, that such contracts are akin to public goods and appropriately provided by governments; and third, that such contracts should be mandatory in applying to significant areas of concern, but should also contain an optional or suppletive component. We have said nothing about the content of such mandatory codes (except that they would reflect the terms knowledgeable individuals), who could transact costlessly, would themselves work out. To develop some understanding of what this means in the case of nonprofits, it is necessary to look at some important characteristics of the entities that reside within this so-called third sector.

1.3 Applying Organizational Law to Nonprofits

At the most basic level, the contractual agreements worked out by an organization's founders must serve two purposes: they must establish an organizational form and structure that is suited to the achievement of agreed objectives; and, they must incorporate mechanisms that provide contracting parties with assurance they are not taking unacceptable risks.

All contractual arrangements entail certain risks because contracts cannot be fully specified and costlessly enforced, but these risks are greater in some arrangements than in others. Organizations generally have well-defined, easily monitored and enforced contracts with their lenders and suppliers. In some trusts where specific beneficiaries are identified, the latter have legally enforceable claims for fulfilment of the trust deed. The long-term contractual arrangements that establish how control is exercised within an organization are more problematic. As with any long-term arrangement, mechanisms must be established to address eventualities that cannot be fully anticipated in such contracts. There is also a need to take account of the costs and the potentially significant complications in monitoring and enforcing such contracts.

In preparing a model organizational charter for nonprofits, therefore, the government must consider, first, what sorts of organizational forms and structures will allow nonprofits to achieve their objectives; and second, what types of contractual terms and mechanisms – or, in other words, what type of governance arrangements – respond to the need of those participating in nonprofit activities for reasonable safeguards. We elaborate on each of these in turn.

1.3.1 Supporting Organizational Diversity

There are a number of theories attempting to explain the role of nonprofits. Some emphasize the role of nonprofits in providing collective goods that governments cannot easily provide due to political constraints and/or institutional rigidities.[7] Others focus on the contribution of nonprofits in markets where consumers have considerable difficulty assessing services and where for-profit suppliers thereby have an incentive to cut back on quality.[8] In other explanations, the view that nonprofits are a response to market or state failures is replaced by an emphasis

on the unique role and contribution of these organizations: their contribution, for example, as a means for the expression of altruistic impulses and as a vehicle to develop civic traditions and promote a sense of community.[9] In terms of the current discussion, what is significant is that the identified roles are compatible with a broad range of organizational forms and structures.

The theories help us understand why we find nonprofits providing a range of services to designated beneficiaries, their members, and to the general public. Some of these activities are appropriately pursued through a corporate form, some through a trust, and some through a voluntary association. Many nonprofit services are directed to filling needs within specific communities; their organizational structure reflects their community focus. As distinct from community organizations, national and regional nonprofits will have a more complex structure based on their need to coordinate services that are delivered through local offices or by affiliates. Nonprofits that sell their services in commercial markets are likely to be organized differently than nonprofits that are dependent on charitable donations. And nonprofits that depend heavily on volunteers will tend to be structured somewhat differently than organizations that are operated by paid employees.

In recognition of the need to accommodate a variety of organizational arrangements, governments have tended to frame flexible laws that allow the founders of nonprofit organizations considerable discretion. Under the largely "enabling" regimes that exist in most countries, founders have broad scope to choose the form of the organization, the relationship between the affiliates, the specific activities of the board, the nature and degree of internal monitoring and reporting, and various other matters. An enabling approach accommodates the need for a range of different organizational forms and structures. It also permits experimentation and innovation, which, over time, can contribute to the development of new and more efficient organizational arrangements. Carefully crafted enabling legislation, however, is not simply permissive; it anticipates the important issues that the organizers of different types of nonprofits will need to address and offers options. Older regimes of organizational law did not give adequate recognition to this additional role of enabling legislation.

1.3.2 Governance Issues

Governance arrangements establish the basic ground rules that determine who has what decision-making authority, the nature of their accountability, and the distribution of risks and rewards among stakeholders. In for-profit organizations, the challenge has been to establish governance that creates strong incentives for wealth creation. In nonprofits, as with government itself, attention must be given not only to the influence of governance arrangements on organizational efficiency, but also to their implications for the manner in which organizational objectives are established.

While the issues are different, all organizations that involve a delegation of authority must address the problem of ensuring decision makers are accountable. In a world of incomplete contracting, there is necessarily concern that "agents" who have been delegated decision-making authority will pursue their own interests rather than those of the "principal." The conflict of interest that gives rise to agency problems may involve various members of the organization. In nonprofits, significant agency problems may arise in the relations between the members and executive of an association, between the donors and the managers of a charitable organization, and between the controlling directors and other stakeholders in a voluntary social service agency. The challenge is to devise governance arrangements that limit these agency costs. More specifically, there is need to ensure that losses arising from any divergence in the interests of principals and agents have been brought under control, and that this has been achieved through mechanisms and monitoring arrangements that do not in themselves entail inordinate costs.[10]

Organizational laws can help mitigate the agency problem, but they are not the only, nor necessarily the most appropriate, solution. The common law imposes a duty on trustees and other agents to serve the interests of their principals with "care" and "loyalty." In addition, market forces can constitute an important

disciplinary mechanism. In the literature on for-profit corporations, much attention has been given to the role of market-driven controls in constraining agency costs that result from the separation of ownership and control. Important market controls include: equity markets, which provide an evaluation of the implications of managerial decisions; managerial labour markets, which strengthen incentives by linking management rewards and opportunities to performance; and, takeover markets, which provide an opportunity for either dissident shareholders or outside investors to change the corporation's direction and management. The operation of these controls is linked to the presence of shareholders who have a financial stake in the profitability of the corporation and an incentive to respond to market signals of inferior performance.[11] While the market-driven controls applying to for-profit corporations have limitations,[12] it is generally recognized that they make an important contribution to reducing agency costs.

Nonprofits also benefit from the deterrent effects of the common law and the disciplinary impact of market forces. But these mechanisms operate differently in a system in which there are no owners with a financial interest in the performance of individual organizations. It is a well accepted principle in economics that assets are most likely to be used efficiently if they are controlled by the party that reaps the benefits from their use – and bears the cost from their misuse. Those who bear the cost of inadequate performance are not as clearly defined in nonprofits as in for-profits, and the exercise of control by these participants is accordingly more problematic.

To be sure, nonprofits have stakeholders. They are likely to include those who donate their time and money to an organization, along with the beneficiaries of nonprofit activities,[13] and those individuals who fulfil both roles in some significant cases. In some circumstances, stakeholders have both the incentive and the ability to take advantage of the control mechanisms that exist. But the nature of stakeholder involvement, and the impact of the common law and market forces in reducing agency costs, varies considerably among different types of nonprofits.

Consider, first, the safeguards against agency problems within the common law. The courts have long deemed that agents have a "fiduciary" responsibility to serve the interests of beneficiaries loyally, and with the same care that agents would apply to their own interests. Fiduciary obligations exist in a variety of circumstances, and, in the case of nonprofits, they have been applied not only to the obligations of trustees, but also to the responsibility of corporate directors and managers.[14] However, as we discuss in the next chapter, the common law governing the duties of nonprofit fiduciaries is confused. The way the fiduciary principle has been applied to corporations, and in some (but not all) cases to nonprofit corporations, it comprises a relatively weak standard.[15]

Fiduciary requirements are clearer and more significant in the case of trustees. To meet their legal obligations, trustees must act for the exclusive benefit of the beneficiary (the duty of "loyalty"), and exercise a high degree of prudence (the duty of "care"). But fiduciary constraints on trustees are not significant if donors and recipients are not in a position to enforce their rights. This would be the case where gifts are created through the contribution of a large number of small donors, each of whom has little incentive to monitor the trustee's performance; or, where the trust results from the bequest of one or more large donors. Enforcement by recipients is problematic if the intended beneficiaries have not been clearly identified. Where gifts are directed, for example, to "medical research" or to "help the needy," there is no beneficiary that is capable of bringing action in the courts.[16]

Market forces are a potentially more significant control mechanism than the common law. Nonprofits that compete for donations are subject to market pressures, as are those organizations that must compete for members, and nonprofits that sell their services in markets supplied by for-profit, public sector and/or other nonprofit providers. Nonprofits cannot survive if they cannot gain the support of donors, win government contracts, or satisfy the needs of household purchasers of social services. Yet, markets for donations and for nonprofit services tend

to be subject to serious deficiencies. The ability of a nonprofit to gain market share may not reflect its efficiency so much as the influence of tax subsidies, contributions and volunteer labour in reducing the organization's market prices relative to other, and particularly for-profit, suppliers. Donors are required to make their choices on the basis of very imperfect information on nonprofit activities and achievements. Moreover, to the extent individual donors delegate this task by contributing to a common fund, the finances of particular charities will be based on the allocative procedures of the common fund rather than the charities' ability to satisfy the preferences of individual donors.[17]

The inability of markets to provide a very clear message complicates the monitoring of agents in nonprofits. This puts an added burden on directors who are charged with overseeing nonprofits. In some nonprofits, as a result of the high costs of monitoring and the lack of pressure on directors from donors and other stakeholders,[18] there are relatively weak incentives for the careful monitoring of management.

In other nonprofits, external market forces, operating in conjunction with the organization's internal mechanisms of control, have established a better environment for addressing agency problems. This is generally the case in mutuals or clubs, where the officers of the organization are elected by and, thereby, directly accountable to the members.[19] The overlap between providers and patrons, which is an important feature of some mutuals, also exists to a significant extent in a number of community-based nonprofits.[20] For example, a day care centre, which is founded by a group of parents to serve their own needs, and perhaps those of other parents, is likely to be controlled by parent-directors that have a strong interest in closely monitoring the activities of the centre's employees. In certain nonprofits, those who have a significant stake in the organization by virtue of their volunteer activities may serve as important monitors of organizational performance.

Agency problems may also be limited, to some extent, by the tendency of nonprofits to attract those who are committed to their values and objectives. There is a self-selection process, which reduces the likelihood of opportunistic behaviour by managers and employees of nonprofits. But there is no foolproof system to identify those – be they trustees, directors, managers or workers – who can be freely entrusted with decision-making authority. Moreover, the moral commitment of those involved does not in itself ensure that an organization is pursuing appropriate objectives. Value systems often clash. The required assurance that the objectives of an organization reflect the wishes of stakeholders comes not from the character of decision makers, but from the existence of an adequate system of accountability.

Agency problems vary considerably among nonprofits. But these problems are potentially significant, and the inability of common law and market forces to ensure agency costs are brought under control suggests that there may be a role for organizational law in helping to establish the required safeguards.

1.4 The Limitations of Organizational Law

To effectively address agency problems, organizational laws would need to incorporate those safeguards that are not provided by the common law or by market forces, and that knowledgeable stakeholders would want to be included as part of the organization's governing charter. We can most easily get a sense of what this means if we assume initially that we are dealing with a universe of identical organizations. The task policymakers face then is to discover the governance arrangements, say *G*, which would be established in a perfect market. The objective, in other words, should be to support the development of those governance arrangements that would be created if organizations' founders were in a position to sell their claims in a competitive market and, thereby, bear the full costs of any departures from efficient governance. The gains from government involvement consist of the economies that are achieved in working out and implementing the appropriate arrangements, or, alternatively, the losses that are avoided from preventing the establishment of less efficient governance structures. The larger are these gains relative to added administrative and compliance costs, the greater will be the resource savings to the economy.

It is clearly very difficulty to approximate the governance arrangements that would be worked out in a perfect market. Even in a universe of identical organizations, governments would have difficulty identifying those safeguards that are necessary to give expression to the wishes of knowledgeable stakeholders and that will act to facilitate, rather than discourage, the use of the nonprofit form. Establishing a policy that minimizes public and private sector administrative and compliance costs also represents a significant challenge.

In the real world of diverse nonprofit organizations, the task confronting policymakers is still more complex. Now governments must respond to a situation where there are a large number of optimal governance arrangements. To some extent nonprofits can be grouped according to their organizational characteristics, and policies can be directed to the needs of different organizational categories. This is shown in the next chapter where we give explicit attention to the question of categorization. There are limits, however, to the extent to which it is feasible to subdivide nonprofits. Some distinctions, such as those between mutual nonprofits in which directors are elected and nonprofits that do not have a defined membership, are fairly easy to draw and they merit attention because they do signify agency problems of a quite different nature. But other potentially important distinctions are difficult to give operational expression. While, for example, agents in nonprofits that sell their services in competitive markets tend to be subject to significant discipline, giving statutory expression to this characteristic is likely to be problematic. Moreover, the implementation of a policy that is based on such categorization would require a very high degree of administrative discretion.

Therefore, while some legislative distinctions can be drawn, policymakers must still address the needs of relatively broad categories containing organizations with quite different governance requirements. There is no one optimal governance arrangement, for example, for the large group of charitable or public benefit nonprofits. All governments can reasonably do is address common governance issues and allow organizations freedom to extensively tailor arrangements to their particular requirements.

Policymakers must recognize the limits of what is achievable through laws of general application. Governments cannot solve agency problems, nor mandate optimal governance arrangements. Organizational laws, however, can add to the safeguards provided by markets and the common law by targeting specific issues that respond to concerns of a broad range of nonprofit stakeholders.

1.5 Policy Objectives

The broad purpose of organizational law is to encourage confidence in, and facilitate the use of, the nonprofit form. There is an increasing recognition that institutions situated between the market and the state have an important role in developing and nurturing a nation's social capital. In addition to delivering services that cannot be adequately or efficiently provided by the public sector or by for-profit organizations, nonprofits give rise to traditions of civic involvement and help foster networks of trust and mutual aid. Recent research has demonstrated that both political governance and socio-economic performance are significantly influenced by the level and quality of a jurisdiction's social capital.[21] There is, therefore, a strong public interest in supporting the growth of organizations that increase citizen engagement in public issues, enhance mutual trust and respect for the law, and expand the forms of horizontal cooperation and coordination.

Given the practical constraints discussed in section 1.4, we believe that a supportive legislative framework can best be achieved through an emphasis on three considerations. First, in keeping with the facilitative role of organizational law, there is a need to accentuate its enabling characteristics. Mandatory requirements in current legislation must be reviewed to determine if they are indeed necessary, and desirable. With respect to matters of organizational form and structure, legislation should be almost fully enabling; in the absence of evidence that some organizational arrangements are superior for certain nonprofit activities and founders are disregarding this evidence, laws should allow a realization of the benefits that come from experimentation and innovation in organizational design. The enabling features of

the law should be strengthened through provisions that anticipate the contractual issues that may need to be addressed by different types of nonprofits and offer options to those establishing governance arrangements and developing organizational bylaws.

Second, the mandatory requirements incorporated in organization law should centre on protecting the fiduciary role of nonprofits. As we have observed, fiduciary controls do not effectively resolve agency problems. They are simply an initial line of defence that protects stakeholders from fraud and waste, and from the misdirection of their funds. But potential fiduciary problems are a significant concern to stakeholders of all nonprofits, given the uneven protection afforded by market forces and the difficulty of using the courts to enforce fiduciary obligations. Moreover, trustworthiness from a fiduciary standpoint gets close to the heart of what it means to be a "nonprofit."[22] The nondistribution constraint applying to nonprofits exists largely to promote such trustworthiness. Strict fiduciary controls would serve the public interest in preserving the meaning and goodwill associated with the concept of "nonprofit."

Third, there is a need to strengthen the basic safeguard that is available to nonprofit stakeholders as a consequence of their ability to "exit."[23] Stakeholders can exit by letting their memberships in mutuals expire, by withdrawing their volunteer services, or withholding their financial contributions. Exit and "voice" are the two primary mechanisms by which stakeholders in any organization can exercise influence. In widely-held corporations, there are mechanisms to allow shareholders to voice their opinions and concerns to management, but these are not well developed;[24] shareholders rely instead on their ability to exit by selling their shares and allowing the movement of the stock price to provide appropriate signals to management. On the other hand, in democratic states, where exit is a costly and difficult option, laws and institutions protect and promote opportunities for citizens to use their voice. While exit is a low-cost option for most nonprofit stakeholders, improved information is needed for exit to become a more effective safeguard and a more reliable signalling mechanism. One of the objectives of policymakers should be to strengthen this mechanism by promoting better information disclosure.

These three considerations guide our examination of nonprofit organizational and supervisory law. In the next chapter we examine a number of specific issues relating to charitable trusts, nonprofit associations and incorporated nonprofits. In each case we ask whether specific requirements are justified by the need to protect the fiduciary role of nonprofits, or to provide adequate information to stakeholders. Our examination of existing legislation proceeds from a recognition of the importance of facilitative law and the need to root out requirements that are unnecessary to protect stakeholders, or that are excessive and unreasonable.

In Chapter 3, we focus on the supervisory and enforcement activities of government. Here again, the emphasis is on the need to eliminate unnecessary regulatory requirements while giving expression to the importance of effective fiduciary controls and enhanced information disclosure. A number of existing regulatory mechanisms and approaches are examined in an effort to identify the features that should be incorporated in a model supervisory regime.

1.6 The Need for a Clear, Coherent Legislative Framework

To develop a legislative framework that facilitates and encourages nonprofit activities, it is necessary to reform the structure, as well as the substance, of nonprofit law. As a result of the initiatives undertaken in different jurisdictions, what has evolved in Canada is a patchwork of confusing and sometimes contradictory laws. There is strong need to bring some order to the existing system. Along with our examination of the elements of organizational and supervisory law, therefore, we look at what institutional changes are needed to achieve a clear, coherent policy approach towards the nonprofit sector. It is important to reform existing arrangements to provide a more stable and certain regulatory environment for participants, and also to conserve the limited public resources available for addressing the legislative needs of this sector.

2 Laws Governing Organizational Form

In this chapter, we suggest numerous criticisms of current organizational laws and make concrete recommendations for reform. Our discussion builds on the two observations developed in the previous chapter concerning the extraordinary diversity in the sector, and the lack of stakeholders in the sector with an interest and status comparable to the shareholder of a business corporation. These features pose a substantial challenge to governments intent on developing responsive organizational laws. As suggested in Chapter 1, we believe that legislation that is responsive to this reality and that is based on an understanding of what can be reasonably achieved through organizational law would be designed with three objectives in mind: facilitation (via adequate enabling provisions); prevention of fraud and misrepresentation (via strong fiduciary controls); and enhancement of market controls (via ample information disclosure).

After reviewing, in a first section, some preliminary matters relating to the current legal framework and the scope of required reform, our discussion in Chapter 2 develops as follows:

- *Definition and Classification* – In this section we establish several schemes of classification of nonprofit organizations. These are helpful in analyzing the organizational law problems in the nonprofit sector. The schemes we introduce provide a vocabulary detailed enough to differentiate among the multitude of factors that go into making an appropriately responsive set of organizational laws. We propose that any reform of the law in this area make use of similar distinctions.

- *Accessibility* – In this section, we examine three questions relating to advisability of imposing restrictions on the availability of any of the three forms of organization. Currently, the purpose trust is available only for purposes that are charitable. We ask whether this restriction continues to have merit. We also question whether there should be any formal restrictions on entry into any or all of the forms, such as a public registration requirement or a prior vetting of objects and bylaws by some state agency. Finally we examine the question whether the ongoing viability of an organizational form should be conditioned on a (minimal) periodic review.

- *Civil Capacity* – Three related questions are addressed in this section. The most important deals with the legal capacity problems posed by the unincorporated association's lack of legal personality. We deal with this in some detail. We then briefly examine whether the civil capacity of any particular organizational form should be regulated by an *ultra vires* doctrine and whether some special provision should be made to govern preincorporation contracts, as under the current business corporations statute.

- *The Content of Fiduciary Duties* – The main issue in this section is the proper definition of the duties of nonprofit fiduciaries. This issue divides into several subsidiary questions: 1) whether a general duty of care and loyalty should be formulated and incorporated in a statutory provision; 2) what should be permissible in terms of the indemnification provisions and liability insurance provided by nonprofit organizations to their fiduciaries; 3) whether self-dealing transactions should be permitted, and if so, under what conditions; and 4) whether the investment and borrowing powers of nonprofit fiduciaries should be restricted or regu-

lated in any way.

- *Membership and Internal Governance* – In this section, we sketch the considerations that should be taken into account in designing appropriate membership structures and membership rights of the numerous types of nonprofit organizations. In particular, we ask how nonprofit organizational laws might be fashioned in order to facilitate the participation of members in the governance of their nonprofits.

- *Enforcement of Fiduciary Duties* – Here we look at whether there should be a derivative action or something akin to it in the nonprofit sector organizational laws. We also look at the advisability of some government agency playing a formal internal role in enforcing fiduciary duties.

- *Regulation of Fundamental Changes* – Here the concerns are whether fundamental changes should be permitted, and if so, under what conditions. For example, should mergers be permitted between nonprofit sector organizations of different types?

- *Regulation of Distributions* – In this section we examine the types of restrictions on distributions appropriate to nonprofit organizations.

2.1 The Current Legal Framework and Scope of the Required Reform

Surprisingly little attention has been devoted in Canada to the design of organizational laws for the nonprofit sector. With a few notable exceptions,[25] the Canadian laws on organizational form, at both the provincial and federal levels, are, as a consequence, seriously flawed and seriously dated. Reform is long past due.

The three main forms of organization – the corporation, the unincorporated association, and the charitable purpose trust – as presently instantiated in Canadian law, all suffer from serious defects. In the case of the corporation, the defects are due, in part, to the legislator's practice of adopting without sufficient thought legislative models designed with only the business corporation in mind;[26] in part, they are due to the perennial difficulties Western legal systems have encountered conceptualizing the obligations of directors and the rights of shareholders.[27] In the case of the purpose trust, current problems stem mainly from the complex Anglo-Canadian jurisprudence on the definition of charity and on associated doctrines establishing the invalidity of noncharitable purpose trusts.[28] With respect to the unincorporated association, current difficulties are due almost entirely to the lack of a satisfactory juridical basis for this institution.

The limited effort on the part of Canadian governments to date can be summarized briefly. In the mid-1960s in Ontario, the Lawrence Committee undertook a comprehensive review of all of Ontario's corporations laws.[29] It completed its work in 1967 with a report dealing with the business corporation only.[30] The federal government undertook a major review of its nonprofit corporation law in the late 1970s and early 1980s. This effort ended in a proposal for a new nonprofit corporations act. The proposed legislation died on the order paper in November 1983.[31] A similarly extensive effort in Alberta in the late 1980s resulted in an innovative proposal for a new nonprofit corporations law. That proposal has not been enacted.[32] There was a major study of the law of trusts conducted by the Ontario Law Reform Commission (OLRC) in the late 1970s and published in 1984.[33] The Commission's study made a few very important recommendations touching on the law of charitable purpose trusts.[34] The legislation that was proposed by the Commission has not been enacted. Two provincial law reform agencies have recently studied the desirability of adopting legislation extending the purpose trust form to noncharitable purposes.[35] One of these has also looked at fiduciary conflicts and at the legal problems associated with funds raised by public appeal.[36] No legislation has resulted from any of these efforts. Only Quebec, with its innovative provisions in its new civil code on unincorporated associations,[37] Saskatchewan, with its adoption of the nonprofit corporations law proposed by the federal study,[38] and

British Columbia, with its *Society Act*,[39] have made any significant advances in the area of nonprofit organizational law.

The seeming indifference of Canadian governments to the organizational needs of the nonprofit sector is no doubt of concern to those with an interest in the health of the sector. What is perhaps more distressing is that none of the limited effort so far has been conducted on a coordinated basis. The provinces and federal government each proceeded independently and proposed unilaterally. Had this disorganized process borne more legislative fruit, there would be, in Canada, a pointlessly rich variety of innovative organizational laws.[40] There can be but few advantages, and many disadvantages, to the normative diversity in organizational laws that success in all of these endeavours would have entailed. The legal issues associated with nonprofit organizational law, although challenging and complex, do not vary greatly across Canadian jurisdictions. Even the major systemic differences between Canada's two private law traditions do not give rise to a need for organizational laws of vastly differing types. Diversity, to the extent it is felt to be needed or required, could easily be accommodated by model organizational laws that allow for some limited jurisdictional choice in the few provisions where such choice might be desirable.[41] Diversity resulting merely inadvertently from uncoordinated reform efforts would lead to further normative chaos.

This lack of a sustained or concerted legislative effort has meant that Canadian courts and Canadian public administrators have had to address many of the problems presented by organizational law on an ad hoc and piecemeal basis. In Ontario in the mid-1980s, there were a number of court decisions dealing with several of the more difficult organizational law issues.[42] Of these, the most difficult, from a legal point of view, dealt with the legality of charitable corporations remunerating their directors for work done for their corporation.[43] The Office of the Public Trustee in those cases took the somewhat controversial stand that all such remuneration requires the prior approval of a court.[44] The Public Trustee has since maintained that this strict standard applies even to the case of a charitable corporation paying premiums on a director's and officer's (D&O) liability insurance policy.[45] This rather extreme view is, in fact, supported by a line of English cases which appear to say the directors of charitable corporations are "trustees" and are therefore prohibited "in equity" from dealing in any way with their corporation.[46] In two leading cases, two Ontario justices essentially expressed their agreement with this reasoning.[47] We discuss this specific issue and others related to it below. We raise it at this juncture merely to make two introductory observations. First, the law relevant to this issue, like much of the organizational law of the nonprofit sector, is old and complex and needlessly expensive litigation was required to resolve it. Second, the particular resolution hit upon by the courts in this instance (i.e., that directors of charitable corporations may not deal with their corporation except with prior court approval), as in several others, is not, from a practical point of view, entirely satisfactory.

It is instructive to contrast the Canadian experience with the experience in the United States and in England and Wales. In 1987, the American Bar Association published a new model nonprofit corporations act to replace its 1952 *Model Nonprofit Corporation Act*.[48] The American Bar Association effort was a coordinated national effort conducted over 10 years, utilizing the experience and expertise of numerous nationally recognized experts in the field of nonprofit organizational law. Those experts relied in part on innovative state level laws adopted previously in New York in 1967[49] and California in 1983.[50] The result, the *Revised Model Nonprofit Corporations Act* (RMNCA), has now been adopted in six states. This success was followed quickly in 1992 by another innovative proposal, the National Conference of Commissioners on Uniform State Law, *Unincorporated Association Act*, 1992, which deals comprehensively and coherently with the organizational problems faced by unincorporated associations. This legislation has now been adopted in three states.

Efforts in England and Wales have been similarly extensive, if somewhat differently oriented. There have been two major government studies in recent

years and several substantial nongovernment studies, all of which led eventually to a major renovation of the regime governing charities in England and Wales.[51]

The task of rethinking nonprofit organization law is, as a consequence of some of the difficulties identified, a challenging one. It requires an understanding of the nature and diversity of the sector, as well as an appreciation of the complexities of the law of these three badly instantiated forms. As we suggested in Chapter 1, one of the state's primary objectives in providing organizational laws for the nonprofit sector is to make available general forms of association for nonprofit organizations that will allow them to function efficiently and effectively. Another is to protect the sector from fraud and waste and, in some cases, to actually aid in the pursuit of certain publicly oriented nonprofit purposes by taking the initiative to compel nonprofit fiduciaries to pursue their organization's objectives faithfully and diligently. As matters now stand, the current laws, judged in light of these goals, are abysmal failures. We proceed to examine those laws in detail.

2.2 Definition and Classification

2.2.1 Introduction

As a first step in designing organizational laws, it is necessary to identify the main types of nonprofit organizations. The failure of the current set of laws to address this preliminary issue is one of the major contributors to the lack of clarity and coherence in those laws. Nonprofit organizations can be classified in several ways. Of relevance to the proper framing of organizational laws are the following five schemes of classification:

1) classification by legal form of organization (principally, the trust, the corporation, and the unincorporated association);

2) classification by function (principally, the foundation and the operating organization);

3) classification by specific nonprofit purpose (principally, religious, charitable, political, and mutual benefit);

4) classification by the identity of the beneficiaries of the nonprofit activity (principally, members and non-members of the nonprofit organization); and

5) classification by sources of financing (principally, private donations, public donations and government grants).

Five schemes of classification is not as extravagant as it may at first seem. Each scheme proves important to the proper formulation of nonprofit organization laws. Some, such as the first, are obviously more important than others.

As a rough illustration of the need for several schemes of classification, consider the variation in policy concerns relating to organizational laws in the following cross section of the sector: a parish church funded by its parishioners; a children's aid society funded by a government ministry; a private foundation established and controlled by a wealthy family; a community trust, such as the United Way, funded by public donations; and a private golf club controlled by its members. When one thinks of such issues as the need for members meetings, the accountability of fiduciaries, the techniques for enforcing that accountability, the permissibility of an organization making a distribution to its members in any form, the possibility of a merger with another organization of a different type, the reformulation of an organization's purposes, and the distribution of assets on dissolution, the appropriate solutions vary considerably depending on the nature of nonprofit organization under consideration. In turn, the nature of the organization depends critically on where it fits in these schemes of classification.

That there should be such diversity, with a corresponding need for differing legal treatments, is not, upon reflection, surprising. Similar variation is present in the for-profit sector and this variation, in turn, is consistently and systematically reflected in

the legislative treatment in place there. Current organizational law in the for-profit sector, for example, distinguishes among partnerships, business trusts, investment trusts, financial institutions, cooperatives, business corporations, closed corporations, public corporations, multinational corporations and Crown corporations, all in a variety of ways. There is no reason to expect that the nonprofit sector, being just as diverse, would require a legal regime that made any fewer classificatory distinctions. Indeed, one of the best examples of nonprofit corporations law, the *Revised Model Nonprofit Corporation Act*,[52] makes and uses all the same distinctions.

We discuss each scheme of classification, and its relevance to organizational law, in turn. The main differences in regulatory treatment are in the following areas: distributions and membership repurchases; conflicts of interest and conflicts of duty; indemnification; and the level and type of state supervision.

2.2.2 Classification by Form of Organization

The three main legal forms of organization are the purpose trust, the corporation and the unincorporated association. There are other legal institutions, in addition to these three main ones, which, because of their relative lack of importance, we do not discuss.[53]

The trust is a centuries old legal institution pursuant to which a person, the trustee, undertakes to administer a certain locus of wealth, the trust *corpus* or property, for the benefit of a person or persons or for a charitable purpose. The trust is established, in the traditional legal language, by a "settlor" or "testator." For convenience, we use "founder."

In this chapter we are concerned with only the purpose trust. As intimated in the definition, the purpose trust is available only to that subset of nonprofits that are charitable. The main practical advantages of the charitable purpose trust are three: it can be established with relative ease, that is, without any prior authorization or certification by the state; it can be established to last in perpetuity; and it will be enforced by the Crown, under its *parens patriae* jurisdiction, and supervised and enforced by courts, exercising their equitable jurisdiction. The state in these latter two ways involves itself in the execution of the founder's charitable intention.

This form is peculiarly appropriate for certain sorts of charitable activity. The two most obvious are: funding the charitable activities of other charities, for example, a hospital foundation funding the activities of the hospital; and establishing a series of discrete charitable gifts over a long period of time, for example, a scholarship endowment funding an annual entrance scholarship. Its main restrictions or disadvantages are two. First, it lacks what might be termed "operational versatility." Compared to the corporation, it is not sufficiently flexible or versatile for the needs of organizations with complex operations, such as hospitals, universities, and children's aid societies.[54] Second, the current rules governing the behaviour of its fiduciaries and the current regulations governing fundamental changes are too restrictive for the needs of many organizations in the nonprofit sector.

The unincorporated association is contractual in legal origin. In many ways, it resembles a partnership. It differs from a partnership, of course, in that the purpose of the founders of an unincorporated association is other than profit, whereas the purpose of the partners in a partnership is profit. The principal legal idea informing the internal and external relations of the unincorporated association is that its members, or some of its members (the "executive") are mutual or reciprocal agents and co-principals of each other, in respect of the affairs of the association. This means that each is responsible for the contracts and, possibly, the torts of the others. The main practical benefit of this form is its ease of formation. It is impossible to say for certain, but it is probable that this organizational form is the most popular in Canada. It occurs whenever two or more people agree to join together to pursue some nonprofit objective. The principal disadvantages are the liability exposure of its members and its lack of civil

capacity. These disadvantages can be extremely debilitating. It is fortunate that very few legal disputes involving unincorporated associations actually reach the courts.

The nonprofit corporation is a creation of statute. Its comparative advantages are many and, as a consequence, it is far more important in Canada as a form of organization than the trust.[55] It offers limited liability protection for its fiduciaries and its members, perpetual succession, legal personality, and operational versatility. It is appropriate as a form of organization for any operationally sophisticated nonprofit, from hospitals to private schools to dining and sports clubs to religions. Its main disadvantages are the costs of entry and the costs of maintenance.

There is no question that these three forms will continue to be the three main forms used by the nonprofit sector. Organizational law, therefore, should continue to be expressed in legal concepts and legal vocabularies appropriate to each of these forms. Thus nonprofit fiduciaries should continue to be "directors" and "officers," if their nonprofit organization is a corporation, and "trustees," if their organization is a trust, even if in all relevant respects the actual content of the fiduciary duties happens to be the same. Similarly, nonprofit corporation law and unincorporated associations law will have to make adequate provision for the participation of members, but membership will not be a relevant concept in the case of charitable purpose trusts.

The principal aim of the legislator in drafting appropriate organizational laws should be to strike a proper balance between the need to treat like issues alike across the three forms with the need to maintain the conceptual and terminological integrity of each of the forms, as modified appropriately to reflect the needs of the sector. In striking this balance, the legislator should also make appropriate use of the concepts and terminology already in place in the respective commercial or private analogues. Certainly, it is a failing of much of the current law that it is designed solely with the commercial or private analogue in mind. Remedying this failing, however, does not require an entirely new set of concepts or terminology. Rather, maintaining the appropriate level of conceptual and terminological consistency with the law establishing the private or commercial analogues will make the new nonprofit sector organizational laws readily understandable, and, therefore, more easily usable by the nonprofit sector actors.

The final product of this endeavour should be a set of organizational laws that are comprehensive and coherent, fully responsive to sector needs, and that are expressed in a way that is clear and certain. Clarity and certainty in the formulation of fiduciary duties and fiduciary rights and powers, especially, are required to attract and keep good people in the control and direction of nonprofit organizations. We make specific proposals in the appropriate places below.

2.2.3 Classification by Function of Organization

By function, there are two types of nonprofit: granting or funding organizations, "foundations," and operational organizations, "operationals." The essence of the distinction between the two is that foundations receive investment or donation income and use it to fund the activities of other individuals or other organizations, and operationals, regardless of their source of funding, actually deliver some nonprofit service or carry on their own nonprofit activities. The distinction was first made, ineptly, in a 1950 revision to the *Income Tax Act* provisions dealing with charities, then properly, in the same statute, in a 1976 overhaul of the same provisions.[56] It is currently used in the *Income Tax Act* to establish two different sets of norms governing the eligibility of charities to receive donations that qualify for favourable tax treatment in the hands of donors. Under the current provisions of the *Income Tax Act*, both foundations and operationals[57] are required to disburse annually a percentage of their receipted donations; in addition, foundations are required to disburse a percentage of the value of their investments.

From the point of view of organizational law, this division of nonprofits is relevant in thinking about several matters. In the case of foundations, there are three policy questions, in particular, all relating to the proper scope of the investment and granting powers of foundation fiduciaries. These are: whether nonprofit fiduciaries should have the power to delegate investment decisions to financial experts; whether nonprofit fiduciaries should be restricted in the types of investments they are permitted to make; and, whether the decisional framework applicable to trusts – generally, unanimity in the exercise of any discretionary power – is appropriate to the foundation form. Foundation fiduciaries will typically want to be able to delegate investment decisions to experts by, for example, buying mutual funds. They will want to be able to invest in a wider range of investments, including program-related investments, than is permitted under the current default regimes. And they will want to be able exercise their granting discretion by majority vote, or consensus, not unanimously. In general, a nonprofit foundation, such as a community foundation, a private research foundation, or a hospital foundation, thus requires more flexibility in the exercise of its investment and granting powers than may traditionally be permitted by the law of trusts, even if the trust form of organization is otherwise the best suited to its needs.[58]

In the case of operationals, some of the current rules governing nonprofit corporations – otherwise the most appropriate form of organization for operationals – are not sufficiently flexible or are not at all appropriate for many of the kinds of activities carried on by operationals. For example, the affiliate/subsidiary system, available as a matter of course to business corporations, does not adequately address the analogous needs of nationally organized nonprofits with regional or provincial chapters or a delegate voting system. Similarly, the provisions governing delegation of fiduciary decisions, fiduciary indemnification, and member participation in corporate governance in current nonprofit statutes do need meet the needs of complex operationals that provide sophisticated services to the public.

We make specific recommendations using this distinction in the appropriate places below.

2.2.4 Classification by Purpose of Organization and by Destination of Benefits Produced

It useful to examine purposes and destination together, since they are closely related in their import.

A dominant idea in the economic literature on nonprofits identifies the "nondistribution constraint" – the prohibition against the distribution of any surplus to owners or members – as the essential element in the definition of "nonprofit." The same notion can, however, be usefully expressed in a more positive and telling way. Instead of saying that an organization is a nonprofit because none of the benefits it produces are distributed to its owners or members, it can be said that an organization is a nonprofit because all the benefits it produces go to advance some specific nonprofit purpose. Currently, Canadian corporations statutes usually list a miscellany of such purposes, typically in a nonexclusive way.[59] Our suggestion is that these lists can be pared down to four or five items in a way that helps substantially in the formulation of nonprofit organizational law. The following exclusive categorization, in our view, is the most useful: religious, public benefit – together these first two constitute the "charitable" class of traditional charity law – political, and mutual benefit. Public benefit could itself be divided into social welfare, meaning essentially economic aid to the materially, physically or mentally disadvantaged, and philanthropic, meaning essentially support for such things as museums, art galleries, and universities.

The destination of the benefit for religion is difficult to identify. Some might say it is the members of the religion who benefit from their support of it and, therefore, that all religious nonprofits are really mutual benefits. Others would argue that the concept "benefit" in this context connotes material benefit

and in the case of religious worship the concept is therefore inapplicable. For constitutional law reasons, and for reasons arising out of the general desirability of respecting the self-understanding of religious nonprofits, our scheme favours the second view. Similarly, in the case of political activity, the material benefit flowing from the support of the organization may be so dispersed as to not really be a factor at all – the organization lobbies to change the law for (its conception of) the public good. Alternatively, the organization might lobby for legislative changes that benefit it or its members directly. (We would tend to classify the second as a mutual benefit.) In the case of public benefits, the destination of the benefit is mainly individuals other than the individuals who support the organization. The distinction between social welfare and philanthropic is relevant here, however, since this last claim about the destination of the benefit is more true in the case of the former – think of CARE, for example – than the latter – think of a donation to the Royal Ontario Museum by an habitual patron, for example. In the case of mutual benefits, the destination is, by definition, the members of the organization.

The implications for organizational law of these two schemes of classification are many. As a sample of some of the areas of relevance, consider the following issues: whether the government's formal role in the organizational laws should be different for religious, mutual benefits and political, compared to public benefits; whether the law governing fundamental changes, distributions and dissolution should be more restrictive in the case of public benefits, compared to the others; and, whether the rights of the members of mutual benefits should be different in key respects from the rights of members of religious organizations. We make more specific recommendations below.

2.2.5 Classification by Sources of Financing

The relevance of looking at sources of financing in designing organizational laws for nonprofits is that degree of accountability of the nonprofit fiduciaries varies, in part, according to how the nonprofit is financed. Public policy makes a similar distinction in the case of public and private corporations. Hence the vast regulatory apparatus of the Canadian securities commissions.

We would divide the sources of financing into commercial and donative,[60] and in the donative category identify the following sub-classifications: private donations, membership donations, public donations, and government grants.

"Commercials" are nonprofits that are financed through sales of goods or services. The National Geographic Society (with its magazine), a nonprofit hospital, and a museum or church store are examples. With commercials, there will be a large measure of accountability flowing from their product market.

In the donative category, the first subclassification identifies private wealth, the second, a reasonably cohesive membership, the third, a dispersed donor base, and the fourth, the government sector. Obviously, the fiduciary accountability issues vary substantially across these four types of nonprofit organizations. With "privates," the organizational concern is the opportunity for self-dealing. Usually, if private wealth is the dominant source of financing, then control of the nonprofit rests in the hands of the donor. One thinks of corporate and family foundations, for example. This concern with self-dealing explains the very restrictive regime that applies to private foundations under the *Income Tax Act*. It also explains the prohibition in Ontario against charities owning businesses.[61]

An organization that relies on its membership for financing, or on repeat appeals to the public, is subject in some measure to external discipline and might, therefore, be expected to be more responsive to fiduciary duty concerns and more effective in delivering its promised benefits. Reliance on government grants, finally, imports a different type of accountability altogether – bureaucratic and systematic perhaps, but also, possibly, lethargic and inattentive.

Classification by sources of financing may be more of a continuum than the others. Further, in the case of any particular organization, there usually will be several different types of financing in place. Few nonprofits fit squarely and exclusively in just one. However, the distinction identified remains important in the formulation of organizational law, and we use them in generating recommendations below.

2.3 Accessibility

There are currently two notable restrictions governing access to nonprofit forms of organization. Both concern charitable nonprofits. One concerns the purpose trust, the other, the charitable corporation.

With respect to the first, as stated already, the purpose trust is available only where the purposes of the trust are exclusively charitable. If the purposes are exclusively charitable, courts will extend a great deal of leeway to the founder of the trust in respect of the degree of certainty required in the language used to establish the trust.[62] Essentially, if the charitable intention is present, courts will intervene to fashion the details of a scheme that will ensure that the intention is carried out.[63] As a further benefit of the trust form, the founder may be assured that a charitable intention, if expressly desired, is pursued in perpetuity. This is because the Crown and the courts will intervene in the administration of the trust to ensure its due execution to the end of time. Founders who attempt to deploy the purpose trust form, but whose intention is not exclusively charitable, will find (usually) that their "trust" lasts only 21 years, that it will not be enforced to the same extent by the Crown or the courts, and that it will not be afforded any of the other benefits extended by courts of equity to charitable trusts. This is the case even if the proposed trust has a purpose that is laudable and publicly beneficial. Under the current law, the purpose must be "charitable" in accordance with the technical legal definition of that term.

With respect to the second restriction, since November 1, 1989, the Ontario Ministry of Consumer and Commercial Relations sends applications for letters patent of incorporation for charitable corporations to the Office of the Public Trustee for the Public Trustee's approval. Ostensibly, this practice is justified by the discretionary nature of a grant of letters patent. The Public Trustee vets the letters patent of incorporation for compliance with the law of trusts.[64] In essence, the Public Trustee requires that the letters patent of incorporation contain provisions imposing trustee fiduciary standards on the corporation's directors.

Since the main aim of organizational law is to facilitate nonprofit activity, there should not be any unnecessary barriers restricting access to the three forms of organization. Ease of entry, it will be recalled, was one of the main advantages of both the trust and the unincorporated association. On the other hand, there are a number of considerations that suggest that access to all or any of the three forms might, with justification, be restricted. First, the state does have an interest in ensuring that it is not called upon to enforce trusts whose purposes are purely idiosyncratic or without any substantial public benefit. Second, the state has a definite role to play in protecting at least the public benefit subsector from fraud and waste. Third, and finally, although enhanced accessibility was one of the key components of the reform of business corporation laws in the 1970s and 1980s, it is still the case that the incorporation of a business corporation requires the registration of the constitutive documents, and it is still the case that a certain minimal level of public disclosure of information is required initially and on an annual basis. Noncompliance is usually sanctioned with diminishment or loss of civil capacity.[65] The ostensible objective of this registration and annual information disclosure is to enhance, to a limited degree, the public accountability of the fiduciaries of these organizations.

In our view, the law should balance the competing considerations in the following way. First, registration of constitutive documents and minimal initial and annual disclosure of information should be required in the case of corporations, charitable unincorporated associations, and all purpose trusts.[66]

Second, this information should be available to the public in much the same way that the same information concerning business corporations is available to the public. This would be a component of a more complete reporting system for nonprofits, the other elements of which are discussed in Chapter 3. Third, it is not advisable in our view that the state be co-opted via trust law doctrines into enforcing private purpose trusts. Rather, the current position of lack of viability is preferable provided there is some loosening up in the definition of "charity" (so that, for example, it corresponds better with modern notions) and provided some other provision is made for a less expansive viability that does not involve the state. There are a number of workable models in this latter regard, which it would be well to consider.[67]

2.4 Civil Capacity

2.4.1 The Incidents of Civil Capacity

The fiction of legal personality entails the legal consequence that the corporation can own property and be a titulary of rights, sue and be sued in its own name, and be bound by and benefit from civil obligations. These rights are the main incidents of civil capacity, that is, the capacity to act as a person in private law. Legal personality therefore entails that the fiduciaries of the corporation and others involved in it, including members, employees and agents, are not by virtue of their particular connection to the corporation, liable for its obligations (thus "limited liability"). It means as well that these persons have no direct claim to the property of the corporation.

Similar effects are achieved with the trust form. There is, first, the trust property, which in equity must be used exclusively for the purposes of the trust. Trustees may in some instances sue and be sued in their capacity as trustees. Trustees may contract in such a way as to charge the trust property, but not engage their own liability, and in any event they are almost always entitled to be indemnified by the trust against obligations incurred for the trust.[68] Trust beneficiaries – there are none in the trusts of concern in this chapter – are not, as such, personally liable for the obligations charged on the trust. Trust beneficiaries also have no direct property interest in the specific assets held by the trustee, only a claim against the trustee for breach of trust and a so-called "equitable" title in that property.

Unincorporated associations, however, face serious difficulties in this domain. There is considerable case law surrounding the issue, most of it notable for its lack of clarity.[69] There are three aspects to this problem:

First, unincorporated associations cannot own property or receive gifts of property. In the usual case – a gift of real or personal property to an unincorporated association – the gift simply fails. Sometimes courts will use other legal devices to uphold such gifts. For example, frequently the gift can be construed as a gift directly to all the present members of the association, or as a gift to the fiduciaries of the association to be held in trust for the benefit of the present members. If the association is exclusively charitable, it might also be possible to construe the gift as a gift in trust for its purposes. Generally, however, these constructions are not available, because generally the donor's express intention is to benefit "the association" and "the association," as such, does not exist in law.

Second, it is not possible to sue an unincorporated association nor is it possible for an unincorporated association to sue. Therefore, in most jurisdictions, in order for a suit involving an unincorporated association to be successful, all the members of the association have to be joined as defendants or plaintiffs.

Finally, lacking legal personality, the association has no capacity to take the benefit or suffer the burden of civil obligations arising in contract and tort. Therefore, principals acting on behalf of an unincorporated association can bind only themselves in contract and tort, not "the" association

or "the" association's property. A few courts have used the idea that the members of the unincorporated association are mutual agents of each other.[70] With this notion, as in the law of partnership, the court is able to say that the juridical acts and facts of each of the mutual agents binds the others. However, in large organizations imposing liability on remote members on this basis would not be fair.

The lack of civil capacity, or of a satisfactory and legally stable alternative, is a major impediment to the operating capabilities of unincorporated associations. Here the law completely fails in its facilitative role. The problem requires the attention of Canadian legislatures. There are two possible models, both acceptable in our view.

The first is the National Conference of Commissioners on Uniform State Law, *Unincorporated Association Act*, published in 1992. Prior to this model act, there was no comprehensive and coherent treatment of all the issues in the common law world. The model act adopts the general solution that the association is to be treated as a legal entity for all purposes of civil capacity. Alternatively, the Province of Quebec has adopted provisions in its new civil code that regulate the same issues in a different but no less effective, way. The Quebec provisions are based on the legal idea of partnership.

Both models are effective. The crucial difference between the two, between an entity and a partnership approach, is the nature and extent of the liability of the members for the juridical acts and facts of the fiduciaries of the association. On an entity theory, because there is a distinction in law between the members and the entity, there is no liability in members as such for the civil obligations of the entity. Further, like a corporation, the entity can own property and be the titulary of rights, sue and be sued, all in its own name. On a partnership theory, there is liability in at least a select group of members, those who might be identified as its executive or leaders. They would, however, be entitled to an indemnity for obligations incurred on behalf of the association and the regime can be designed so that they are liable only for the contracts, not the torts, of their mutual agents.[71]

2.4.2 *Pre-incorporation Contracts and the* Ultra Vires *Doctrine*

Two other matters of lesser importance require brief consideration in this section. One has to do with the status of contracts entered into on behalf of a corporation that is not yet in existence. The other is the legal consequences of acts entered into by agents of a corporation on its behalf that are *ultra vires* the corporation.

A 19th century English decision laid down the rule that the agent of a nonexistent principal is personally liable on a contract entered into on behalf of the nonexistent principal.[72] In the case of a corporation in the process of being formed, the rule provided further that, upon coming into existence, that corporation had no power to ratify or adopt the contract. The holding was subject to more benign interpretations, but the rule became entrenched as stated. It poses problems for nonprofits in the corporate form that transact business prior to incorporation. Modern business corporations statutes typically contain provisions that override the rule and provide for more sensible conclusions. Similar legislation is required in the case of nonprofits.

The *ultra vires* doctrine also originated in mid-19th century English corporate law.[73] It states that legal acts entered into beyond the specific objects or powers of a corporation, as stated in its constating documents, are void.[74] Another limb of the rule provides that acts of directors or agents beyond their delegated powers are voidable, but may be ratified by shareholders. The *ultra vires* doctrine was held not to apply in the case of corporations formed by letters patent of incorporation in the early 20th century.[75] This holding was codified in some jurisdictions, such as Ontario, in a statutory provision stating that the corporations have the capacity of a natural person.[76] It is common for modern business corporations statutes to provide likewise.

The rationale for the doctrine historically was to protect the investors in the corporation from fiduciaries taking business risks not initially contemplated in the objects of corporation. Secondarily, it was also justified on the theory that the corporation was a creation of legislative will and could pursue only those objects expressly permitted in the act of incorporation. The principal defect of the doctrine was that it tended to catch innocent creditors of the corporation by surprise. Their contracts with the corporation, otherwise fair and reasonable, could be declared void at the instance of the shareholders of the corporation, at great financial loss to them.

The doctrine has a slightly different relevance in the case of nonprofits. Since there are no shareholders with a financial risk, the doctrine cannot be justified on the traditional basis that it protects investors. It is possible to argue, however, that the point of its application to nonprofit corporations is to preclude the application of donated funds to purposes not contemplated by donors. Donors might, consequently, be given standing to upset transactions not contemplated by the objects. There is no case law applying the doctrine to nonprofits in this way.

Although it is common for nonprofit corporations statutes to provide permissively that corporations may be incorporated for various kinds of nonprofit objects, often, as in Ontario, the same statutes provide that the corporations incorporated thereunder have the capacity of natural persons. The nature of the interplay between these two provisions is not clear. One appears to take away what the other appears to give. The confusion is exacerbated by the fact that the objects clauses of nonprofit corporations are frequently restrictive and badly drafted.[77] The restrictiveness is especially marked in the case of charities that are required under the *Income Tax Act* to be exclusively charitable to be registered.

Any reform of these matters should adopt the same strategy as is adopted in the case of business corporations. The modern business corporations statutes provide that shareholders still have the right to require fiduciaries to comply with the objects, but do not visit the sanction of nullity on the acts of the corporation, which are beyond its powers. Legislation is required immediately to alleviate the unnecessary uncertainty caused by this outdated doctrine.

2.5 Fiduciary Duties

2.5.1 Introduction

The law governing the duties of charitable and other nonprofit fiduciaries is also in a very confused state. The confusion arises mainly from the fact that this body of law has two contradictory organizing tendencies. The problem originates exclusively in the law of charity, and emanates menacingly from there.

One tendency has been to address the issue of fiduciary duties from a unified perspective, on the basis that fiduciary duty law in the nonprofit sector presents a single problem whose various elements do not vary according to the form of organization. Courts operating from within this framework have tended to treat all charities, no matter what the organizational form, as in some sense "trusts," and therefore as subject to the fiduciary duty rules that govern trustees.[78] From this perspective, the obvious technical question arises whether it is the corporation or the directors of the corporation who are the trustees. Neither way of specifying the mechanics of the application of trust law really works: if the corporation is the "trustee" – a logical deduction since it owns the property – then there typically is never a fiduciary problem since the corporation itself is rarely, if ever, involved in any breach of trust; if the directors of the corporation are the trustees – also a logical conclusion since they are in any event fiduciaries under corporate law – then the difficulty lies in identifying the trust property, since directors of a corporation do not own any "trust" property.[79] Statements supporting both of these equally incoherent points of view can be found.[80]

The other tendency in the law has been to treat the issue of fiduciary duties as three discrete problems, each to be addressed from within the framework of the particular organizational form in question. Courts addressing issues from this perspective look to the

fiduciary law governing directors of corporations, trustees of trusts or principals of unincorporated associations for their doctrinal inspiration. Since the corporate law standards are not, it seems, as onerous as the trust law standards, different standards are applied through this technique to different organizations solely on the basis of their form of organization, even if in all other relevant respects the organizations under consideration are identical.

In the first tendency, classification by nonprofit purpose prevails over classification by nonprofit form. The ultimate goal is normative unity, with convergence on the supposedly higher trust law standard. In the second, the objective seems to be to maintain the conceptual and terminological integrity of the respective forms; the result, accordingly, is a variation in normative standards according to form. Interestingly, there is no tendency to normative diversity using any of the other schemes of classification: fiduciary standards thus do not explicitly vary according to a nonprofit's function, its sources of financing or the destination of its benefits. Nor are other distinctions made within the classification by purposes – only charity is picked out for special treatment.

The divergence in organizing tendencies is explained mainly by the fact that historically both supervisory law and organizational law governing charity were equitable,[81] but that currently the dominant form of organization is the corporation. The doctrinal union of supervisory law and organizational law worked well in England in the 18th and 19th century when most charitable organizations were trusts, but does not work well in Canada today when most charitable organizations are corporations or unincorporated associations.

Resolving this confusion, and all issues associated with it, is of immense practical importance because, as already suggested, clarity in the formulation of this part of the law, in particular, is critical to getting good people to take on the risks of leadership in the nonprofit sector. In what follows we examine the most important areas of difficulty. These are: the proper formulation(s) of the general duties of care and loyalty; the appropriate treatment of fiduciary remuneration, indemnification, insurance, and other instances of self-dealing; and, the advisability of imposing restrictions on the investment and borrowing powers of nonprofit fiduciaries.

2.5.2 The General Standards of Care and Loyalty

2.5.2.1 Introduction

In general, the duties of fiduciaries can be divided into two types: a duty of care and a duty of loyalty. The duty of care requires that the fiduciaries act with a specified level of competence and a specified level of attention in the pursuit of the objectives of their nonprofit organization. The duty of loyalty obliges the fiduciary to act exclusively in the best interests of the organization. Generally this means that the fiduciary must act honestly and in good faith in the pursuit of the particular organization's stated objectives.

The duty of care, for the purposes of analysis, has two parts: the element establishing the level of skill or competence the fiduciary is expected to bring to the job; and the element establishing the level of attention the fiduciary must pay to the job. The two parts are in many contexts closely related. As an illustration, consider the following question: Are fiduciaries who are not personally capable of evaluating an issue, entitled, or even obliged, to consult with and rely on the opinion of experts? A strict duty of competence might prohibit such persons from serving in the first place. A less strict duty of competence might oblige them to consult. A strict duty of attention might require them to learn. A less strict one might permit them to sleep through that part of the meeting.

The duty of loyalty is also divisible into two parts. The first, of greater importance, consists of duties arising in situations where the fiduciary's general duty to act loyally in the best interests of the trust, corporation or association is in material conflict with the fiduciary's own self-interest, broadly understood. These situations are termed, alternatively, conflicts of interest or, when there is an actual transaction, self-

dealing. They encompass everything from theft,[82] to nepotism, to remuneration for services provided, to fiduciaries using organizations' property for their own benefit. A second division, of lesser importance, consists of duties arising in situations where fiduciaries use the fiduciary power to pursue some interest other than their own, broadly understood, *and* other than the organization's. A fiduciary, for example, may owe conflicting duties to two separate organizations. Or a fiduciary may use the funds of hospice to open a school.

We examine the issues touching on the duty of care and the duty of loyalty separately in what follows.

2.5.2.2 The Duty of Care

The duty of care can be breached in a multitude of ways. Occasionally, it happens that well-meaning board members defer to the judgment of a particularly energetic and confident board member who may be involved in some breach of the duty of loyalty.[83] Or zeal in pursuit of a worthy cause may lead to errors in judgment, such as overcommitting the limited resources of the nonprofit. Or an improvident transaction may be entered into or a poor investment decision taken after an inadequate review by the board. It is impossible to tell how substantial the losses in the nonprofit sector are due to this type of fiduciary error. Undoubtedly such losses occur. The issue at this juncture is the nature and scope of the liability of fiduciaries for these losses. That in turn depends on the standards of performance imposed on them in the first place.[84]

At common law, in the case of corporations, the standard of care expected of a fiduciary was set out in *City Equitable Fire Insurance Co.*[85] In that case it was said that directors of a corporation owe "what may reasonably be expected from a person of his knowledge and experience." There is some case law applying this standard, but the case law is thin because, in fact, directors are not sued very frequently for breaches of their duty of care.[86] The standard is generally thought to be quite low. It is said to be "subjective" because it places so much emphasis on the director's own prior ability.

There has been a debate for a number of years over whether the competence component should, in fact, vary relative to backgrounds of individual directors. In *Escott* v. *Barchris Construction Corporation*,[87] for example, a lawyer who signed an amendment to a prospectus was held liable for failing to make a reasonable investigation of the truth of the statements in the prospectus, something that he should have known he was bound to do because he was a lawyer. On the basis of such a differentiation, lawyers and accountants on nonprofit boards might be held accountable on a higher standard than other members. For example, a tax lawyer or accountant might be expected to object to an expenditure that would jeopardize the exclusively charitable status of a charity.[88] Alternatively, different higher standards might be imposed on fiduciaries of charities, lower or variable standards on fiduciaries of mutual benefits. Something like this regime now applies in the case of Canadian financial institutions.

In the United States, courts have developed a slightly different approach to evaluating alleged breaches of the duty of care by corporate directors. American courts apply the so-called "business judgment rule." This rule is formulated as a standard of judicial review. Under the business judgment rule, American courts will not review a business decision taken by a board of directors if the directors have acted honestly and in good faith and provided they have taken the appropriate measures in investigating the issues underlying the matter to be decided.[89] Thus the leading formulation of the rule states:

> [There is] a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.[90]

Typically, it is said that the presumption will be set aside where it can be shown that there has been a breach of the duty of care defined, usually, as an act

of "gross" negligence or that there has been a breach of the duty of loyalty defined, typically, as a duty to avoid conflicts of interest. Where the board's action is successfully impugned on the basis of a failure to comply with the duty of loyalty, the court will set aside the presumption in favour of business judgments and conduct a review of the behaviour on the basis of the "fairness of the transaction."

The general value of the American approach lies in its recognition that directors of complex enterprises know better than courts what uses to make of the enterprise's resources. This logic is in many respects as applicable to charities and other nonprofits as it is to business associations and, consequently, the business judgment rule has been applied in the United States in the nonprofit context.

The current formulation of the duty of care in the law of trusts subjects all trustees to a single objective standard – "the man of ordinary prudence in the management of his own affairs." This standard was adopted in the late 19th century by the House of Lords in a famous set of decisions, and has been accepted and applied in Canada.[91] It is thought to be stricter than the corporate law standard, although it has never been very easy to say exactly how or why. In any event, its ostensible harshness is alleviated a great deal by a statutory provision, common in the Anglo-Canadian world,[92] which permits a court to relieve a trustee from liability for breach of this duty where the trustee "has acted honestly and reasonably, and ought fairly to be excused for the breach of trust, and for omitting to obtain the directions of the court." This statutory provision has been used by courts to develop a more subjective standard, one that takes account of various factors, including the professional experience of the trustee. In one case, *Fales* v. *Canada Permanent Trust*, for example, Dickson J. found that the trustees had breached their duty by not disposing of trust shares in a timely fashion, resulting in a loss to the trust; one of the trustees, a housewife with four children and limited investment experience was exonerated under the statutory provision, while the other, a professional trust company was not.[93]

Given this state of the law, there are two main questions. 1) What should the general standard be? In particular, a) should it vary according to organizational form or purpose? or b) should it vary according to the particular skills of the fiduciary? c) if the latter, should fiduciaries be permitted to rely on the advice of qualified experts? and finally, d) what should the attention component be? 2) Should the standard or standards be codified?

1. a) We see no sense in devising a set of general standards that vary according to form or purpose. The standard, whatever it might be, should be the same for all nonprofits, regardless of form or purpose.

   b) Rather, we support the view that the competence component of the standard should be flexible enough to accommodate the inclusion on nonprofit boards of individuals with different qualifications. Different standards for fiduciaries of different backgrounds is sensible, in our view, because of the deliberative nature of nonprofit boards. As deliberative bodies, they are expected to bring together people of differing experiences and abilities to evaluate alternatives for action. The underlying assumption ought to be that everyone present is alert to the implications of a decision from the perspective of the information and principles of which they are knowledgeable. Diversity in community representation, for example, will often be a more important selection criterion for board membership than investment expertise or business acumen. Conversely, a higher duty on professional trustees might be justified on the basis of their being remunerated, the representations they have made as to their ability, and the reasonable expectations of the persons who engage them. Legislation acknowledging the validity of a moving standard has been proposed in some jurisdictions.[94] We think it is required in all jurisdictions in Canada.

c) If there is to be a variable standard of competence as we suggest, then explicit provision should also be made in all the organizational laws to allow for nonprofit fiduciaries to delegate some of the decision making to qualified experts. The current system requiring nonprofit fiduciaries to make all their fiduciary decisions themselves is quite unrealistic in this day and age.

d) With these two attenuating measures in place, there is no reason why the attention component should not be reasonably rigorous. We would suggest a standard of due diligence.

2. Should the standards be codified? In our view the answer is definitely yes. Some jurisdictions have already adopted codifications of the duty of care. Under section 25 of the British Columbia *Society Act*, for example, directors must "exercise the care, diligence and skill of a reasonably prudent person."

   The OLRC in its report on trust law, following the lead of others, recommended the following standard be codified: "that degree of care, diligence and skill that a person of ordinary prudence would exercise in dealing with the property of another person."[95] We think that codification has obvious merit. It would help make clear the personal commitment people are making when they join a nonprofit board. It would thereby act as a further encouragement for good people to serve.

A related question is whether the codified provision should be suppletive or imperative. Should nonprofit organizations have the option of lowering the standard of care required of their fiduciaries or doing away with it altogether? This is a possibility currently under the Delaware Corporations Code, for example. While this type of provision may be appropriate in the commercial domain, we would argue, based on the considerations discussed in Chapter 1, that it is not appropriate in nonprofit legislation.

2.5.2.3 The Duty of Loyalty

Formulation of the general duty of loyalty is a straightforward task. All modern corporations statutes provide a general formula to the effect that corporate fiduciaries must act honestly and in good faith in the best interests of the corporation. Similar formulations have been proposed for trust law. We suggest it would be a good thing to provide a codified statement of the general duty of loyalty for all types of nonprofits. The provision should be identical in formulation to what is presently provided in modern corporate statutes.

The difficult question in this domain is how to deal with some of the specific problems relating to self-dealing transactions. We turn to consider these issues now.

2.5.3 Remuneration, Indemnification, Insurance, and Other Acts of Self-Dealing

At common law, contracts between a director and the corporation were voidable at the instance of the corporation. They were prohibited by a rule of general application, which provided that fiduciaries may not have an "interest that possibly conflicts with the interest of those whom he is bound to protect."[96] It did not matter at common law that the contract was fair and reasonable or that there was no intention on the part of the director to defraud the corporation. The rule prohibited even the possibility of conflict. The corporation, acting by vote of the majority of shareholders or members could, however, ratify the contract.

Modern corporations statutes typically modify this general prohibition in several ways. They typically authorize directors of a corporation to establish their own remuneration. They usually also allow the corporation to indemnify the directors against harms

arising to them in the execution of their duties. They permit a corporation to purchase liability insurance for the directors.[97] In the case of indemnification and insurance, however, the coverage permitted by the statute usually excludes indemnification or insurance for harms caused by or related to a director's breach of the duty of loyalty. Modern corporations statutes also typically contain a general "safe harbour" provision, applicable to all other types of self-dealing transactions. Safe harbour provisions validate self-dealing transactions if three standard conditions are met: the interested director must have disclosed the nature of any conflict of interest to the meeting that adopts the contract; the director must not vote on the contract; and the contract must be fair and reasonable to the corporation.[98] Failure to comply with any of these conditions results in the contract being voidable at the behest of the corporation. The guilty director is liable to a fine and to account for any profits made under the contract. Sometimes this common law rule – the liability to account – is codified in the corporations statute.

Under general trust law rules, any dealing whatsoever by a trustee with trust assets is void, unless approved expressly by the trust instrument, by the beneficiaries unanimously or by the court prior to the transaction. Only the first and third methods are (ostensibly) available in the case of the purpose trust.

Although the current Ontario corporations statute, like its counterparts in most jurisdictions in Canada, contemplates that remuneration,[99] indemnities[100] and insurance premiums can be paid or provided to corporate fiduciaries (unless prohibited by the letters patent or bylaws), the Office of the Public Trustee in Ontario has taken the view that none of these provisions is available to directors of the charitable corporations without the prior approval of a court. This conclusion follows from his view, supported by the case law,[101] that these directors are trustees and therefore subject to the stricter provisions of trust law. Further, the Public Trustee, in vetting applications for letters patent, routinely requires the inclusion of prohibitions against any type of self-dealing.

There are two competing policy concerns at work in this area. On the one hand, there are many situations where nonprofits benefit from dealings with their fiduciaries. For example, a nonprofit that offers reasonable liability protection to prospective fiduciaries increases the prospects of attracting and keeping good people. As another example, fiduciaries who are lawyers or accountants may be able to provide their nonprofit organization with cheaper and more responsive services. Finally, a dance company might want employee representation on its board. All of these innocent and beneficial transactions would be prohibited under a strict standard and are unduly cumbersome under the Public Trustee's standard. On the other hand, in nonprofits where there are not any active members disposed to keep watch over the dealings of the fiduciaries, there is tremendous occasion for self-dealing that is harmful to the nonprofit, and to the sector as whole.

In our view, this is one area of regulation where public benefit and religious nonprofits, as well as private nonprofits, ought to be treated more restrictively than the others.[102] The others should perhaps be subject to a regime comparable to what is currently in place for business corporations. The various interests at stake in the case of public benefit, religious, and private nonprofits are properly balanced, in our view, by a scheme that requires that the bulk of these transactions be subject to a prior vetting on a case by case basis by some government agency with overall responsibility for the sector. The agency would review the transactions for procedural fairness and ensure that the transaction is not only fair and reasonable but also in the best interests of the nonprofit. Remuneration for serving as a fiduciary *per se* should, however, be prohibited altogether for these classes. Transactions involving standard indemnification agreements and standard D&O insurance ought to be approved as a matter of course.[103] Perhaps

these could be cleared, along with other harmless types of transactions, on an expedited basis.

2.5.4 Powers of Investment and Borrowing

The content of certain aspects of the fiduciary duty is sometimes stipulated in more detail by statute. This legislative technique is used in areas of fiduciary activity where there is reason to doubt the ability of fiduciaries to perform to the relevant general standard. Two common areas where there have been provisions of this type deal with the investment powers and borrowing powers of the charitable fiduciaries.

With respect to the former, it is common to find in Anglo-Canadian trustee statutes "legal lists" of investments. In one common variation of this legislative scheme, the "legal list" serves to insulate complying trustees from liability for breach of their duty of care in regard to their investment choices.[104] In older corporations statutes the issue is sometimes dealt with as a matter of the *vires* of the corporation. In Ontario, for example, s. 23 (1)(t) of the *Corporations Act* does not extend to nonprofits the general power to invest funds "in such manner as may be determined." If a nonprofit corporation is to have fuller powers of investment, these must be expressly stipulated in the powers clause. Currently, the Office of the Public Trustee requires that the power to invest for all charities be restricted to investments authorized for trustees. The same investment restriction is imposed by statute in British Columbia on a limited set of nonprofits, namely those providing life, accident, disability, or sickness insurance or pension benefits.[105] Further, the prohibition against fiduciaries delegating decisions mentioned above in the discussion on the duty of care applies with a vengeance to investment decisions, with the effect that, as the law now stands, an Ontario charity may not purchase an interest in a mutual fund.

Similar types of provisions regulate the power to borrow. Many corporations statutes require that the corporation adopt a borrowing bylaw by two-thirds vote, before it is permitted to borrow.[106] Currently the Office of the Public Trustee requires that charitable corporations restrict their power to borrow to borrowing for operations only.

In our view these restrictions no longer make any sense. Both sets of restrictions are far too cumbersome and intrusive. The only apparent effect is to inhibit the dynamism of the sector. Indeed, the restrictions on investments are positively harmful. In line with this thinking, the Charities Commissioners in England have recently stated that it is permissible for charity trustees to delegate investment management to experts.[107] It would be imprudent for most nonprofits to do otherwise. A better approach is required in this area.

With respect to investments, we suggest a much wider legal list, or better still a prudent investor standard, together with a power to delegate investment decisions to qualified financial professionals.[108] In our view there should be no restrictions on the power to borrow. Market conditions will ration credit rationally.

2.6 Membership and Internal Governance

Perhaps the most significant failing of Canadian nonprofit organizational laws is their treatment of the legal status of members, in particular, their treatment of members' roles in the internal governance of nonprofits. This is a problem in the case of corporations and associations, but not trusts, since a purpose trust can have no members. Very little thought is given in the older corporations statutes to the organizational needs of nonprofits with active members and there are no statutory provisions governing the internal affairs of associations, only a modest case law. The problems play out differently in important and sometimes subtle ways, depending on whether the nonprofit is a charitable, religious, mutual, or political. In designing a new regime, therefore, careful deployment of imperative and suppletive rules should be made and a variety of regulatory techniques

– such as draft model articles and bylaws and government provision of informal counsel – should be adopted. For the sake of brevity, we merely list the most obvious deficiencies and needs here.

1) A new law should require that membership rights be clearly defined. It should state that if there are to be different classes of members, one at least should have full voting rights. A new regime should make far more explicit than the current ones do that the articles and bylaws defining the constitutive rights of members must be explicit on voting, dissolution, redemption, and transfer rights.

2) A new law ought to regularize the status of honourary members and honourary directors by explicitly allowing for them and by requiring that their rights and obligations be defined when they are contemplated. Similarly, it ought to regularize the status of self-perpetuating boards. Although these two institutional variations are common in the nonprofit sector, their legal status is unclear since they are generally not provided for in nonprofit corporations laws.

3) A new law should define the variety of permissible governance structures – federated nonprofits and delegate voting systems, for example – that are commonly found in the sector. Suppletive provisions dealing with these matters would help nonprofit organizations give sure and clear legal expression to their current organizational practices.

4) A new law should deal with the problems surrounding the admission of new members. A new law should also make provision for the redemption and transferability of memberships, with appropriate distinctions in this regard according to nonprofit purpose. For example, mutuals might have a very liberal regime, but charitables would have a very restrictive one; obviously, there would be no redemption right in the case of charitables or religious. Similarly, provision should be made to deal with the power of a nonprofit to expel a member and with the corresponding rights of the member.

5) A new law should deal with the calling and organization of members meetings, including voting rights, proxies, voting agreements, member's rights to call a meeting and to submit proposals, etc. It should enhance member access to information, in a fashion similar to what modern business corporations statutes have done.

6) A new law, finally, ought to provide for the possibility of members suing fiduciaries derivatively and suing for relief from oppression. These regimes might vary according to nonprofit purpose. For example, they might be crafted to avoid the possibility of litigation pertaining to a particular religion's doctrine. A member's right to require fiduciaries to comply with the internal law of the organization should also be stipulated.

2.7 Enforcement of Fiduciary Duties

Enhancing member rights and member democracy will contribute to better fiduciary performance and greater fiduciary accountability. In our submissions in Chapter 3, we also suggest that there is an important role for public agencies to play in the enforcement of fiduciary standards, especially in the enforcement of the duty of loyalty. It would be a good idea, in our view, if some public agency had many of the same rights as members in most organizations. This suggestion requires careful implementation, though, since a too intrusive role would be counterproductive. It makes little sense, for example, to allow a public agency participation rights in a deliberative setting, such as an annual meeting. But it does make some sense allowing a public agency the right to sue derivatively for breaches of the duty of loyalty and to sue for compliance. We suggest other supervisory powers in Chapter 3.[109] Further, some elements of the members rights might be made available to classes of nonmembers, such as donors, or classes of donors. In designing such extended accountability regimes, the new law would have to be careful to weigh the organization's interest to be free from frivolous and vexatious suits. One way to do this is to give control over the initial stages of any claim to a public agency or a court.[110]

The law should make use of the social dynamics of board meetings to encourage a higher level of fiduciary performance. Different rules currently apply to fiduciaries who do not participate in a decision that is later attacked for being in breach of the fiduciary duty of directors. Trustees are liable for breaches of trust even if they do not participate in the breach of trust, but at common law, directors are liable only for the decisions in which they actually participate.[111] It is common nowadays for corporations statutes to provide for a presumption of liability for absent directors but provide them with the means to register their dissent and escape liability. Modern business corporations statutes contain other important rules governing the conduct of directors meetings, such as one designed to enhance performance, others designed to make it easier to perform. There is very little in the old statutes on these matters. New legislation should use this type of approach as well.

Beyond these measures, is there anything else that could be done to enhance fiduciary performance? There is much talk in recent years about raising the standard of corporate governance in the private sector.[112] A Toronto Stock Exchange committee recently recommended that every Canadian public company be required to disclose, on an annual basis, a "statement of its corporate governance practices." That statement, in the committee's view, should address the following matters: 1) the mandate of the board, including its duties and objectives; 2) the composition of the board and, in particular, whether the board has a majority of unrelated directors; 3) an outline of the structures in place that would facilitate the independent functioning of the board from management; 4) a description of the board committees, their mandates and activities; 5) a description of the matters requiring board approval; 6) the procedures and place to recruit the directors and to evaluate board performance; 7) the measures in place for receiving shareholder feedback; and 8) the board's expectations of management. Were there a public agency in place playing a role equivalent in objective to the stock exchanges and the securities commissions, it could, in its educational capacity, help develop governance practices appropriate to the sector.

2.8 Fundamental Changes

In the case of charitable purpose trusts, fundamental changes are highly regulated. Typically, in the case of nonprofit corporations, the regulation of fundamental changes is thin and merely suppletive. There is no regulation of fundamental changes in the case of associations. This wide variety of regimes is probably not tenable. Most of the regulatory interests align according to nonprofit purpose, yet the law in this area is differentiated according to nonprofit form.

In the law of charitable purpose trusts, the doctrines of initial and supervening cy-pres are available to deal with changes in circumstances that require a change in purposes. The doctrines provide that a court may modify a charitable purpose trust where the purposes established by the founder are initially or become impracticable or impossible. In the case where the impracticability or impossibility is present from the outset, the court will only intervene to modify the trust if it finds a general charitable intention. Otherwise, the trust is held to fail and the trust property reverts to the founder, falls into his residuary estate, or goes to the alternative named. In the case of supervening cy-pres, the court will intervene to modify the trust if the founder's intention was to benefit charity unconditionally.

The doctrine is frequently criticized for providing too meek a basis for intervention.[113] An American case is illustrative. It had to do with a bequest of oil stock to the San Francisco Foundation for exclusive use in Marin County. At the time of the will, the stock was worth $7-10 million. At the date of death of the testator, Mrs. Meryl Buck, the gift was worth over $340 million. The Foundation applied to the court to alter the terms of the trust to allow it to be used in the entire Bay area, on the basis that there were more pressing uses for the funds there than in Marin County, one of the richest areas in the United States. The court held that the circumstances did not present a basis for the application of the cy-pres doctrine. The case has attracted a great deal of attention.[114]

According to some, the doctrine strikes a balance between the donor's intention to control the uses of property in perpetuity with the public interest in ensuring that the wealth is devoted in a way that benefits public purposes. The charitable purpose trust is a unique institution in the way it involves government in the execution of private intentions, since the Crown and the court undertake to supervise and, if need be, enforce the trust. The *quid pro quo* for this involvement of government is that the founder must intend to benefit a charitable purpose. The proper scope of the court's discretion is best appreciated in the light of this balance. The less the gift "benefits" the public, the less of an interest the state has to be co-opted into the pursuit of the donor's purposes. This would suggest two points of tension in the doctrine: one in the definition of the grounds of intervention; the other in the definition of the scope of the authority to modify the trust. As currently formulated, in the view of most observers, both aspects of this tension are balanced now too much in favour of the donor's intention, since the grounds of intervention are narrowly defined and the court is obliged to modify the trust as close as possible to the original intention. The perennial reform question is whether the grounds for intervention should be expanded to include inefficiency and whether the principle of modification should extend beyond cy-pres.

It has been suggested by some that the best way to balance the relevant considerations in a cy-pres context is to allow the trustees of the trust themselves to decide on new uses.[115] Trustees under this scheme would be entrusted with the decision of determining when the trust purposes are no longer to be followed and to decide what the new purposes should be. Trustees could be expected to act in an enlightened way since their reputations within their own professional community, and their reputation among givers, would be at stake.

This proposal certainly has some merit but it probably goes too far. There will be many instances where the trustees care very little about their reputations or where they themselves have no good ideas on when and how to re-devote funds. A better idea would be to reform the doctrine to require court approval acting on the advice of the trustee. We are in favour of a modest liberalization in the formulation of the grounds of intervention and the authority to modify.

The opposite problem, a regime that is too lax, prevails in corporations and associations law. Especially in the case of charitable and religious nonprofits, a rededication of assets to a new purpose should be highly regulated since frequently donor money is involved.[116] Accordingly, there should be explicit prohibitions against such rededications unless they are approved by a court or by the proposed nonprofit commission, and the basis for change should be limited in ways similar to what applies for trusts.

2.9 Distributions

Distributions may occur during the continuance of the organization or at the end, on a winding up. A sound regime governing fundamental changes is one strong defense against distributions that should not occur. The organizational law must clearly provide that all distributions in all instances, in the case of charitables and religious, and all distributions during the continuance of the organization in the case of the others, are prohibited. Surprisingly, this feature of nonprofit corporations law is also unclear. There is strong regulation in trust law, but once again next to none in associations.

3 Supervisory Laws

In this chapter, we examine governments' role in overseeing and supervising nonprofit organizations. Having put in place an appropriate framework of organizational law, governments face the task of establishing adequate administrative and enforcement mechanisms. Supervisory laws provide governments and their agents with the investigative and monitoring powers they require to ensure that trustees and managers are fulfilling their fiduciary obligations.

The legislation that is of interest constitutes only a subset of all supervisory or regulatory legislation applying to nonprofits. Along with other private sector organizations, nonprofits are subject, for example, to human rights legislation, labour codes, various federal and provincial consumer protection regulations, and municipal zoning bylaws. Governments engage in more specific monitoring to protect their own interests as purchasers of nonprofit services. They oversee particular nonprofit providers to ensure they are satisfying the conditions of government contracts or meeting the terms of grants based on specified requirements. In addition, governments endeavour to ensure that nonprofits benefitting from special state privileges meet the conditions established in relevant legislation. Revenue Canada's efforts to ensure registered charities comply with the law's definition of "charitable" activities and satisfy other obligations under income tax law fall under this latter group of supervisory activities.

While the supervision associated with the enforcement of organizational law is different from the supervision required to meet other policy objectives, there may be significant complementarities to be realized. The possibilities for cooperation that arise particularly in relation to the major enforcement activities undertaken by Revenue Canada, need to be examined. As we discussed in Chapter 1, the overall objective should be to establish an effective framework of organizational law in which administration and compliance costs have been minimized.

The Need for Supervisory Law

Supervisory law is required because of the inadequacies in other mechanisms available to enforce the fiduciary obligations of trustees and managers. Fiduciaries could be brought before the courts by the beneficiaries of trusts, by members of nonprofit associations, and, if the law were changed as we proposed in the last chapter, by major charitable donors. In addition, provincial Attorneys General have standing before the court, allowing them to initiate action where there is no specific individual or group with the right to enforce a trust, and to more generally enforce the fiduciary obligations of charities on behalf of the public.[117] The role of supervisory law is to facilitate enforcement and overcome the limitations, including the expense and delay associated with a court-based process.

The need for separate machinery to investigate possible abuses was initially recognized in England almost 400 years ago with the passage of the *Statute of Elizabeth, 1601*. This set up a body of commissioners who could investigate breaches of trust, and whose decisions could be appealed to the Chancellor. A more permanent investigative body was set up in 1853 when a Charity Commission for England and Wales was established to deal with the neglect and misapplication of many ancient endowments. In addition to overcoming the expense and delay in the court process, the Charity Commissioners filled a record-keeping and fact-finding function that was important for keeping track of charitable gifts and ensuring that they were being used for the purposes intended.

In the current Canadian context, effective govern-

ment supervision can help build public confidence in the nonprofit sector. This should benefit donors, members and patrons of nonprofits, and the organizations themselves. In the case of charities, donors would benefit from the increased assurance that their contributions are being used for the purposes intended. The greater benefit, however, is to the organizations that belong to the charitable sector. An appropriate supervisory regime reduces their vulnerability to fraudulent schemes and to the sorts of scandals that have received prominent attention in recent years in Canada and the United States. These incidents ultimately do more harm to the sector as a whole than to the particular organizations that are victimized. Since scandals are usually uncovered fortuitously, the public reasons that fraud or dishonesty are endemic to the sector as a whole.[118] There is also some loss of public trust when questionable fundraising and administrative practices are uncovered and used to question the general adequacy of controls within the charitable sector. The existence of an effective supervisory agency would go some distance to resolving true problems and strengthening the reputation of the sector.

Effective supervisory law would significantly augment the protection afforded beneficiaries and members and patrons of nonprofits by case law and organizational law. Supervisory law can be used to achieve better information disclosure and greater transparency. Moreover, through a specialized supervisory agency, governments can pursue a broad approach, which extends beyond a policing function to include the promotion of improved administrative practices. The latter is desirable because of the limitations of punitive remedies; while the imposition of financial penalties harms an organization's patrons and members, who are more likely to be victims than willing participants in a wrongful act, the prosecution of volunteer directors for inadvertent wrongdoings can have the undesirable effect of discouraging participation in the direction of nonprofit activities. There are significant advantages, therefore, to having a public agency with the capacity to detect problems early and help trustees address these issues before they become serious concerns. In this regard (as we discuss in a later section), the example of the English Charity Commission is again instructive.

Supervision in Canada

While the regulation of charities is a provincial responsibility in Canada, provincial governments have devoted few resources to supervisory activities. All provincial Attorneys General have standing before the court, allowing theme to act on behalf of the public to restrain the neglect or exploitation of charitable property. But, with few exceptions, the provinces have not established institutional arrangements to support their supervisory roles. The most notable exception is Ontario, which has established an office with specific responsibility for protecting the use of charitable property. Alberta is a partial exception, having enacted significant supervisory legislation aimed at preventing fundraising abuse.

In most provinces, the function that is closest to a supervisory role is exercised by the director or registrar of corporations. Nonprofits that are incorporated under provincial law must comply with procedural and annual filing requirements. The submitted financial statements, which generally have to be audited for larger corporations, are available to the public. None of the provinces, however, have the resources within their corporations branches to review financial statements or to monitor nonprofits for self-dealing and other problems. Corporate reports are not examined to ensure that organizations are adhering to specified objectives. Enforcement of appropriate conduct by officers and directors is mainly left to Revenue Canada, the police (where criminal fraud is involved), and members (New Brunswick) and/or interested parties (British Columbia). In British Columbia, for example, the Minister of Finance and Corporate Relations will launch an investigation only where the activities of an organization raise issues that are of broad public interest.

Outside of Ontario, the role of provincial trustees is confined to protecting the financial interests and legal rights of vulnerable groups. In Saskatchewan, for example, the Public Trustee will engage in a supervisory role in relation to private trustees only where the

interests of children under 18 are involved.

Focus of the Chapter

In this chapter, we look at a number of alternative approaches to supervising the fiduciary role of nonprofits. Our assessment is influenced by the importance we attach to effective enforcement of fiduciary requirements and ample information disclosure, the central objectives highlighted in Chapter 1. Beyond that, our assessment is based on certain general requirements that should be satisfied by government policy: the need to balance the benefits from effective regulation against the costs of the attendant limitations on the freedom and innovative potential of nonprofit managers; the need to choose the least costly among alternative, equally effective supervisory arrangements, where costs include both the resources devoted to administration and the resources organizations must devote to compliance; and the need to fully adhere to the requirements of due process and the Rule of Law.

Our examination attempts to answer some basic questions. First is the federal supervision, which is undertaken in conjunction with the enforcement of tax law, a sufficient safeguard against improper behaviour by nonprofit controllers? This is the subject of the next section. Second, what are the characteristics of an effective and efficient regime for the supervision of nonprofits? We work towards an answer to this question by examining experience in Ontario, which has one of the most developed and active provincial regimes for the supervision of charities, in section 3.2; and by examining the English model of charity supervision, which offers some interesting comparisons with the Ontario approach, in section 3.3. Third, what special controls, if any, are needed to respond to public confusion and concern about fundraising activities? This issue is addressed in the fourth section, which includes a discussion of U.S. policy and fundraising legislation recently introduced in Alberta. The fifth section reviews our conclusions and considers the problems of implementing an efficient approach within a federal system. In an efficient system, there must be attention, as well, to the resources the sector itself devotes to supervisory activities and to the potential role of self-regulation. This is also examined in section 5.

3.1 Supervision by Revenue Canada

More resources are devoted to administration of the charity provisions of the *Income Tax Act* than to any other supervisory activity involving nonprofits. In this section, we consider whether tax enforcement mechanisms provide the required assurance that nonprofits are adhering to their fiduciary duties. The question of how, if at all, the administration of the tax system can be made to better respond to governance concerns is addressed in the last part of the chapter.

The administration of the tax system mirrors the distinction that is drawn in tax law between charities and other nonprofits. The establishment of a separate Charities Division within Revenue Canada, which can be linked to the recommendations in the 1966 Report of the Royal Commission on Taxation,[119] reflects the government's desire to implement a unique regime for charities that would support their development. Over 1996, a staff of 75 within head office and another 15 auditors operating in the field reviewed requests for registration and monitored the compliance of registered charities with the relevant provisions of the *Income Tax Act*.[120] Charities that are granted registration under the Act, either as a charitable "organization" or a public or private foundation, are exempt from taxation and able to issue tax-creditable receipts. Approximately 60 percent of all applications for registration are approved summarily, 20 percent are approved following closer investigation by the Charities Division, and 20 percent are refused.[121]

Revenue Canada has given less attention to nonprofit organizations that are not charities. There is no legislative requirement for registration, and it is left to individual organizations to determine whether they qualify as nonprofits under the *Income Tax Act*. Moreover, until recently, nonprofits that were not incorporated and were not trusts were not subject to

annual filing requirements. This was changed in 1993 and nonprofits now have to file a return if they exceed a minimum revenue ($10,000) or asset ($200,000) threshold, or they have filed a return in the previous fiscal year.[122]

3.1.1 Common Objectives

The broad objective of the tax authorities is to raise revenue for the government. The Charities Division contributes to the achievement of this objective by ensuring that favourable tax treatment is provided only to those organizations that Parliament has identified as worthy of such support. The enforcement of rules, such as those prohibiting charities' involvement in "unrelated" business activities and in "partisan" political activities, can be seen in the context of Revenue Canada's efforts to give expression to the intentions of policymakers, as set out in Section 149.1(1) of the *Income Tax Act*. Revenue Canada's primary interest is in ensuring that the fiduciaries of charities fulfil the requirements for tax subsidies. In a 1990 publication, the department acknowledged that:

> ... charities are accountable to their supporters and to the community at large for adherence to their stated objectives, for prudent management of their affairs, for the conscientious and scrupulous use of funds entrusted to them ...
>
> Government officials cannot hold this critically important sector of Canadian life to these important accountabilities. The registering of charities and the monitoring of their compliance with the provisions of the *Income Tax Act* cannot and does not presume to suggest that the government can vouch for their integrity or performance at all times.[123]

Nonetheless, tax officials' interest in ensuring that charities meet the obligations that accompany their favourable tax treatment might be expected to overlap to a substantial degree with stakeholders' interest in ensuring that nonprofits are prudently managed. The 1990 Discussion Paper on charities suggested as much in observing that "the government assists charities, through the administration of the tax measure, to achieve their goals and meet the demands of public accountability."[124] Indeed, a number of features of the tax system highlight the common interest of governments and other patrons.[125] This common interest is apparent, first of all, in the efforts of the tax authorities to ensure that charities comply with a nondistribution constraint; under the *Income Tax Act*, no part of the income of registered charities can be "payable to, or ... otherwise payable for, the personal benefit of any proprietor, member, shareholder, trustee or settlor...." Second, charities are subject to a minimum expenditure test, which is intended to discourage inappropriate accumulations of capital and put some limits on administrative, including fundraising, expenses. The "disbursement quota" is set at 80 percent, but is subject to a number of exceptions and charities can apply to be exempted from the quota in given fiscal periods. Third, an exception is made to the confidentiality provisions in the *Income Tax Act* (Section 241) to allow public access to information on charities. Within six months from the end of each taxation year, charities must file a public information return, which reports on the purpose and activities of the organization and includes data on receipts and disbursements, assets and liabilities, and remuneration to paid employees.

The interests of patrons in prudent management of charities is also supported by the monitoring process adopted by the Charities Division. The emphasis is on an educational approach that helps managers identify and correct deficient administrative practices. Consulting and Audit Canada, a special operating agency of the federal government, undertakes "operational audits" for the Charities Division. These are broader than the traditional taxation audit, and aimed at uncovering management practices that need correction. An audit of 1,424 organizations conducted over 1992 and 1993, for example, found that 27 percent filed an inaccurate information return, 26 percent had improper tax receipts, 6 percent had improper records, 3 percent failed to meet their spending quota, 2 percent were involved in noncharitable activities, and 1 percent conferred benefits to members.[126]

3.1.2 Limitations of Revenue Canada Supervision[127]

While the tax system affords some measure of protection to patrons, as a general supervisory mechanism it is subject to important limitations. The provisions discussed above apply only to registered charities. There is no comparable attention to the activities of unregistered charities and other nonprofits. Indeed, as already noted, it is only within the last three years that these other nonprofits have been subject to filing requirements. Less than 5,000 such organizations filed returns with Revenue Canada in 1994, and these are thought to represent a fraction of the total number of Canada's noncharitable nonprofit organizations.[128] The limited attention devoted to exempt nonprofits may be sensible in terms of a strategy aimed at effectively using Revenue Canada resources to minimize losses from nonpayment of income tax. But a different strategy is called for if the objective is to target potentially significant fiduciary problems, which may just as easily occur among nonexempt nonprofits as among registered charities.

Even in terms of registered charities, the tests imposed by Revenue Canada leave some important gaps. One of the most important protection available to donors is the assurance that their contributions are directed towards specified objectives. The enforcement of tax law does not give recognition to this implicit contract between donors and the charities to which they contribute. Revenue Canada will not object when organizations alter their objectives so long as resources are still devoted to pursuits that are regarded as "charitable activities" under the Act.

For those organizations that are subject to the "prudent man" rule of trust law, the tests applied by Revenue Canada are much less onerous than those that would be applied by the courts. Tax enforcement cannot ensure that trustees abide by the strict obligations they have under common law in terms, for example, of making prudent investments, or avoiding wasteful expenditures.

While information access can be an important instrument of accountability, the Public Information Return filed by charities has serious limitations. The activities of organizations tend to be described in general terms, limited information is provided on beneficiaries, and disbursements are not disaggregated so as to provide an indication of the importance attached to different objectives and an understanding of how the organization pursues its objectives. Moreover, the department does not endeavour to ensure the accuracy of the information in the public return.[129] In his 1990 Report, the Auditor General reported that public information was missing for one or more years between 1982 and 1987 in 17 percent of the files he reviewed. He found that the department did not systematically attempt to identify and correct errors in the public return and that discrepancies between this and other information available to Revenue Canada could remain unreconciled. The significance of reporting errors has also been noted by researchers using the public information return to measure the size and scope of the Canadian charitable sector.[130]

The information Revenue Canada gathers in its audits and investigations of registered charities would also be helpful to stakeholders, but none of these findings are publicly released. Donors are thus required to make their decisions in the absence of a potentially significant component of information.

In addition, the supervisory role of tax officials is undermined by the limited remedies available under tax law to address problems. The Charities Division cannot remedy improper behaviour by trustees, directors or managers by making the charity whole. When a registered charity contravenes the provisions of the *Income Tax Act*, the Department can revoke its registration and impose a penalty tax.[131] Revocation, however, is an extreme sanction, and one that is totally inappropriate for most problems that are identified. Over the five-year period ending March 31, 1996, only 33 organizations (i.e., 6.5 per year) had their registrations revoked. The 1992 and 1993 audit referred to above resulted in revocation for 1.1 percent of the 1,424 audited organizations. In most organizations (i.e., 53 percent), problems were addressed by the department through an "educational letter." In about a quarter of the organizations, where problems were judged to be more serious, Revenue Canada sought an "undertaking" from the organization that corrective action would be taken.

While a system of monetary penalties could conceivably strengthen compliance, it is recognized that this could have the undesirable effect of diverting funds intended for charitable purposes into the federal treasury.[132] From the perspective of donors, this solution could be more troubling than the problem it is intended to correct. Another route to strengthening the department's supervisory role is to increase the resources it has available to monitor nonprofits. While Revenue Canada represents the country's main monitoring mechanism, the resources deployed by the department to oversee nonprofits are modest in relation to the size of task.[133] It could be argued, however, that any additional public sector resources are most appropriately allocated to an agency that has a broader mandate for overseeing nonprofit activities. This broaches the general question of how to efficiently coordinate enforcement activities, an issue to which we return in the last part of the chapter.

3.2 Supervision by the Ontario Public Trustee

As noted above, Ontario has gone further than other provinces in establishing arrangements for overseeing charities. Although all provinces exercise supervisory powers under companies law and many have significant investigatory powers under their consumer protection laws, Ontario is unique in establishing a supervisory regime that is specifically directed to protecting the public interest in the proper use of charitable property.

3.2.1 Main Legislation

The supervision of charities in Ontario is undertaken by the Charitable Property Unit in the Office of the Public Guardian and Trustee. The unit carries out its role primarily under the provisions of the *Charities Accounting Act*, the *Charitable Gifts Act*, and the *Public Guardian and Trustee Act*. The *Charitable Gifts Act* (CGA) limits the involvement of charitable organizations in business activities "carried on for gain or profit." A charity may not hold more than a 10 percent interest in a business, and any holdings it has acquired in excess of this limit must be disposed of within a fixed period.[134] Proceeds from any disposition must be invested only in investments authorized by the *Insurance Act*.[135] As long as a charitable organization holds more than 50 percent of a business, the Public Trustee is required to help determine the business' annual profit, and the terms for its distribution.

Most of the monitoring and investigatory activities of the Public Trustee are based on provisions in the *Charities Accounting Act* (CAA). This Act requires persons holding property for charitable purposes under the terms of a will or written instrument to provide notice to the Public Trustee (Section 1); and to regularly provide the Public Trustee with any information requested about the property and its administration (Section 2). Charitable trustees, which are expressly defined under the Act to include charitable corporations, are required to provide the Trustee with copies of their constating documents, their annual financial statements, and the registration number assigned by Revenue Canada.[136] When concerned that accounts may not be in order, the Trustee can require them to be examined and audited by a judge of the Ontario Court (Section 3). And when an executor or trustee fails to comply with Sections 1, 2 or 3 of the CAA or is found to have misapplied property, made unauthorized investments, or violated the terms of a will, the Public Trustee can apply to a judge for a remedial order (Section 4). This can lead, for example, to the removal of the executor or trustee and the appointment of someone to act in their stead.

Individuals who are concerned about the way charities (excluding religious and fraternal organizations) raise funds or carry on their activities may complain to a judge, who can order the Public Trustee to launch an investigation (Section 6 of the CAA). An investigation may also result where two or more persons allege that a charity (including a religious or fraternal organization) is guilty of a breach of trust (Section 10 of the CAA). Individuals can file complaints directly with the Public Trustee, rather than

with the courts, and, if necessary, the Trustee can seek court authorization to carry out a formal investigation using its powers under the *Public Inquiries Act*. Under new legislation being introduced, it will be somewhat easier to implement regulations under the CAA and it will possible for organizations to proceed with certain changes (to which all parties agree) without court approval.[137]

3.2.2 Enforcement Activities

The Charitable Property Unit had a staff of 7 (including 3 legal counsel, 1 investigative accountant and 1 examiner), and a gross budget of just over $500,000 in the fiscal year ending March 31, 1996.[138] In carrying out its policing division, the unit is largely complaint-driven.[139] The Trustee can only subpoena documents and summons persons to give evidence when the courts grant it such investigatory powers. In the normal course, the Trustee will pursue those complaints that are judged to merit follow-up through written inquiries.[140] This is a slow process and it often takes some time for officials to determine if there is a potentially serious problem that requires further action. Another major function of the Office is to review applications for provincial incorporation by charities. As noted in Chapter 2, the Trustee checks applications to ensure that they include "special provisions" identifying certain restrictions applying to charities.[141]

A significant portion of the Charitable Property Unit's resources is devoted to overseeing the proper administration of wills. Particular attention is given to the approximately 300 to 500 wills the Office receives each year that provide gifts for a specific charitable purpose, or a charitable purpose selected by the estate's executors.[142] The Trustee's supervisory role takes on increased importance in these circumstances because there are no identified beneficiaries who are in a position to ensure that gifts are applied to their intended purpose. Similarly, the Trustee fills an important gap when it acts to ensure the appropriate disposition of charitable property that has been abandoned or forgotten.

The activities of the Ontario Public Trustee highlight the importance of an effective supervisory mechanism. As originally recognized in England a long time ago, there is a need for a body that can ensure charitable bequests are being applied to the purposes for which they were intended. Similarly, the public interest in the effective fulfilment of fiduciary duties by directors and managers of charitable corporations is advanced when, as in Ontario, stringent controls are being applied against self-dealing, conflicts of interest and other breaches of trust.[143] Patrons are also protected when – again, as in Ontario – there are constraints limiting corporations' ability to divert resources towards objectives other than those to which they were supposed to be applied.

At the same time, a number of issues raised by the Ontario model require further consideration. The activities of the Ontario Public Trustee raise some broader issues that relate, in part, to matters we discussed in the last chapter. Some questions might also be raised about the nature and adequacy of the supervision in Ontario.

3.2.3 Issues

In terms of broader considerations, it is important, first, to recognize that the regulatory environment for charities has been made particularly complex and particularly uncertain by the way in which powers have been exercised by federal and provincial governments. This problem cannot be attributed to Ontario policies, but it is highlighted by the independent approach pursued by the province and its Public Trustee. The Trustee has pointed out, for example, that registration under the *Income Tax Act* "does not confer charitable status on the organization, it recognizes the status it already has according to the general law."[144] As a result, Ontario will not necessarily accept Revenue Canada's interpretation of charitable status. By the same token, Revenue Canada does not see itself bound by the definition of charity in the CAA and by judicial interpretations of that statute. Moreover, since it is the Public Trustee's position that all charitable activities carried out in Ontario are subject to Ontario legislation, an organization cannot

avoid these conflicts by basing its operations outside the province. The consequence is a regulatory patchwork that can add substantially to the compliance costs incurred by individual organizations.

Uncertainty has resulted, as well, from the Trustee's efforts to hold directors of charitable corporations to a standard of care similar to that of trustees. Although it has been recognized that "... there are some grey areas ... [the Trustee] always makes the first approach to any problem from the trust point of view."[145] This approach is partially justified by the CAA, which, under Section 1(2), states that "any corporation incorporated for a religious, educational, charitable or public purpose shall be deemed to be a trustee within the meaning of this Act...." As we discussed in the last chapter, pragmatic considerations argue strongly against the application of the current trust standard to charitable (and other nonprofit) corporations.

While strict enforcement of directors' responsibilities is desirable, it is important that this is based on an appropriate fiduciary concept. In Chapter 3, we have attempted to develop standards that reasonably define the obligations of nonprofit fiduciaries in terms of care and loyalty. The way to resolve current uncertainty is to incorporate clear standards of this type in federal and provincial legislation.

A third broad issue pertains to the restricted focus of the Ontario regime on charities, as distinct from nonprofits generally. While there are some special concerns that apply to the fundraising activities of charities (which we address in a later section), the need for the strict enforcement of fiduciary standards is important in nonprofits generally. The limited role of market-based safeguards is as much a concern in relation to other nonprofits as in relation to charities. The Ontario regime, like the supervisory regime administered by Revenue Canada, thus has an important gap in coverage.

In terms of the adequacy of supervision, what is most notable is the relatively few resources devoted to enforcement activities by the province that is seen to be most active in this area.[146] The Trustee has limited capacity to examine and verify submitted financial statements, some of which are unaudited.[147] The Office does not have the resources to engage in random spot checks, although these can significantly reduce the risks of noncompliance and are generally considered to be a component of an effective strategy of regulatory enforcement.

Fundraising, which is an area of charitable activity that has raised particular public concern, does not receive special attention in Ontario. Under Sections 6(1) and (2) of the CAA, individuals can file a complaint with the Ontario Court "as to the manner in which a person or organization has solicited or procured funds." Complaints made to the Public Trustee are likely to attract the attention of the Office if there is some indication that, by allowing particular public solicitations on its behalf, the organization is not adequately protecting its own interest.[148] There are, however, no prescribed codes of conduct for charities or independent fundraisers, and no special attention is given to the policing of fundraising activities.

In assessing the Ontario model, consideration should also be given to the lack of public disclosure requirements. While much of the information provided to the Trustee is probably accessible through Freedom of Information legislation, the Office does not attempt to make the financial statements and other information in its possession available to the public. In other contexts, mandatory disclosure has been recognized as an effective way to address agency problems and make organizations more accountable.[149] Given the disclosure that already occurs through the federal tax system, what is required is not an additional layer of reporting requirements but cooperative arrangements that would allow Ontario and other provinces to support and benefit from federal efforts to promote disclosure. While it is possible to question the allocation of resources within Ontario, the bigger problem is the lack of cooperation, which has resulted in an inefficient allocation of supervisory resources among public sector participants as a whole.

3.3 Supervision by the Charity Commissioners for England and Wales

The Charity Commission for England and Wales is one of the oldest and most experienced agencies involved in supervising charities. It is of interest for this reason and also because it provides a model of an enforcement regime that differs in some important respects from Canadian experience.

3.3.1 Background and Operations

The establishment of a permanent charity commission in Britain followed the release of a Royal Commission report in 1840, which extensively documented the mismanagement of charitable trusts. Initial legislation, passed in 1853, 1855 and 1860 provided for a permanent Commission solely to supervise the administration of charitable trusts. While the Commission's purview was extended to nontrust charities by a new Act passed in 1960, for a long time thereafter, a large proportion of the Commission's resources continued to be devoted to the supervision of permanent endowments.[150] In the late 1980s, a number of reports were critical of the Commission's oversight of charitable corporations. Although all charities were required to apply for registration and submit accounts to the Commission under the *Charities Act 1960*, there were serious compliance problems. A 1987 report by the National Audit Office (NAO) indicated that, based on a sample survey, less than 40 percent of charities may have submitted accounts to the Commission within the previous five years.[151] And only a limited number of accounts that were submitted were examined each year. The government addressed the concerns raised by the NAO and others[152] in a 1989 Parliamentary Paper,[153] and in 1992 introduced major changes to charities legislation.[154] As a result of recent reforms, the Charity Commission has acquired new powers, along with increased resources, to enable it to more effectively fulfil its supervisory functions.

The supervision of charities in England and Wales is the responsibility of a Chief Charity Commissioner and four other commissioners who are appointed by the Home Secretary.[155] Under the *Charities Act*:

> The Commissioners shall ... have the general function of promoting the effective use of charitable resources by encouraging the development of better methods of administration, by giving charity trustees information or advice on any matter affecting the charity and by investigating and checking abuses.[156]

The Commissioners are thus to promote "the effective use of charitable resources" by being on the lookout for wrongdoing, but also by providing information and advice and playing a supportive role. The Act makes it clear that the Commissioners' duty is to help trustees (who include directors of charitable corporations), and not to interfere in the administration of charities.

A staff of approximately 600, under the leadership of an executive director, carries out the day-to-day operations of the Commission, concentrating on a number of major activities. These include, first, the registration of charities. All charities with an annual income of £1,000 or more and all charities with a permanent endowment are required to register, and, in recent years, the Commission has devoted increased efforts to enforcing this requirement. A second general area is monitoring and investigation, which includes examining financial statements, checking out complaints, and holding inquiries. In 1994, for example, almost 10,000 sets of charity accounts were examined as part of the Commission's monitoring program. In the same year, 523 inquiries were concluded,[157] of which just under 60 percent revealed significant cause for concern. Another major activity is based on the Commissions' power to sanction actions that are outside the powers of charitable trustees but that are judged to be in the interests of the charity. This may involve making a "scheme" to validate changes in a charity's objects, constitute a new body of trustees or expand the powers of trustees, or making an "order" to allow the vesting or transfer

of property. In 1994, the Commissioners issued 1,083 orders and made 677 schemes. A fourth set of activities are centred in the office of the Official Custodian. Property may be vested in the Official Custodian by an order of the Commissioners under their power to protect charities.[158] Prior to the 1992 Act, others also vested property in the Custodian as a way of avoiding conveyancing and related charges associated with trust changes. The process of transferring property back to trustees, as required by the 1992 legislation, is now proceeding and expected to be completed by the end of 1997.

3.3.2 Strengths of the English Approach

As already discussed, we believe that an emphasis on charities is misplaced; while there are some distinct issues that apply to particular types of nonprofits, there are some important overarching concerns that justify attention to the governance of nonprofits generally. Allowing for that general qualification, there is much that we find attractive in the English approach. First, it provides a reasonably unified and coherent approach to charity supervision. While a unified system of supervision is easier to achieve in a unitary than a federal system of government, the English approach is instructive nonetheless. A single agency can realize available economies of scale in administration, and establish a more certain regulatory environment than is possible with a number of decision-making authorities. While there are still differences in the treatment of charities under tax law and under charities law, even here, there have been efforts to find some commonalities. In England, registration with the Charity Commission is seen as providing conclusive evidence that an organization is established for charitable purposes, and that it thus may qualify for tax relief.[159] In addition, there are cooperative arrangements between the tax authorities and the Commission, and Inland Revenue will apprise the Charity Commission of information indicating that charities are involved in noncharitable activities.

Second, as a consequence of recent reforms, the Charity Commissioners now have a well- developed program of monitoring and investigation.[160] A computerized database helps the Commission monitor compliance with reporting requirements and facilitates the examination of annual returns. Indicators are being developed to help identify from the database those charities at risk or in need of remedial action. The Commission's internal monitoring is supplemented by the information it receives from public complaints, the media, the police, Inland Revenue and other sources. While the resources available for monitoring have increased in recent years, the Commission is also attempting to improve the efficiency of its supervisory activities through the use of performance indicators and better management controls. Where the Commission decides there is need to institute an inquiry, it can draw on its extensive investigatory powers. Commissioners may direct any person to provide accounts and statements in writing, to furnish copies of relevant documents in his custody or under his control, and to attend and give evidence. Inquiries may be public or private and conducted by the Commissioners themselves or by a person appointed by them.

Through its monitoring activities, the Commission has attempted to establish an early warning system that allows it to prevent problems before they lead to serious difficulties. Considerable resources are devoted to helping the Commission effectively fulfil its preventative role. In 1995, for example, along with the advice and support provided to organizations identified as needing assistance, some 19,000 inquiries were addressed. The Commission runs seminars and training programs, and distributes a wide range of leaflets elaborating on its role, the requirements of charity law, and the duties of charity trustees.[161] The monitoring, advisory and investigative activities all help to reassure the public that charities are meeting high standards of conduct.

Third, under the *Charities Act*, it is much easier than under Canadian law to remove restrictions that limit the ability of trustees and directors to effectively carry out their responsibilities. The courts and the Commissioners can establish a scheme involving a variety of possible changes in the rules or the administration of

a charity, where this is likely to resolve a problem, or remove uncertainty over the viability of a charity.[162] In addition, as noted above, the Commissioners can allow trustees to overstep their authority when a proposed action is expedient in the interests of the charity. As we discussed in Chapter 2, the power of Canadian courts to accommodate needed changes is much more circumscribed. They can order a scheme only where an existing scheme for the administration of charitable property is incomplete. Similarly, Canadian courts can order charitable property to be applied to alternative purposes (using their cy-pres powers) only where the original purpose has become impossible or impractical. In England and Wales, by contrast, rule changes may be permitted simply because they will allow trustees to use charitable gifts effectively.[163]

Fourth, there is recognition that information disclosure can enhance the public accountability of charities. Within 10 months from the end of their financial year, charities must transmit an annual report on their activities (a trustees' report) and a statement of account to the Commission. Accounting statements must comply with prescribed requirements,[164] which are less onerous for smaller organizations. For charities in which neither income nor expenditure exceeds £10,000, simplified annual reports and annual returns, which have not been subject to independent examination, are acceptable. Larger charities with incomes of £100,000 or less must have their accounts reviewed by an independent examiner, but they can be prepared on a more simplified receipts and payments basis and they need not be audited.[165] The trustees' report, which supplements the accounting statement, must discuss the means employed to promote the charity's objectives; review the charity's activities, achievements and financial position over the period; and explain salient features of the financial report. This information is kept by the Commission and open to public inspection. Trustees must also make copies of their charity's accounts available, subject to payment of a reasonable fee by those who request it.

3.3.3 Some Concerns

At the same time, there are elements of the English approach that we find troubling. In the interests of establishing an efficient supervisory system, the government has provided the Charity Commissioners with extraordinarily broad powers. Under the Act, Commissioners can exercise the same power as the High Court to make schemes and issue orders. To remedy problems, Commissioners have frozen bank accounts, removed and appointed trustees, and prohibited further fundraising.

In making schemes and authorizing dealings with charitable property, Commissioners are required to respond to an application by a charity or the Attorney General, or an order by the court. They can also make certain orders on their own initiative in certain circumstances. Where Commissioners are satisfied that a scheme is in the best interests of a charity and the charity's trustees have failed to respond accordingly, they can proceed as if an application for a scheme had been made. Moreover, as a result of recent legislation, Commissioners need not await the results of an inquiry to issue an order. They can intervene to protect a charity at any time after they have instituted an inquiry and satisfied themselves that 1) there is or has been misconduct or mismanagement, or 2) it is necessary or desirable to act to protect the property of the charity. The Commission's power to appoint a receiver and manager to temporarily run a charity was exercised three times during 1995.

There are provisions for appeal to the High Court against an order of the Commissioners. Concerns about the discretionary power of Commissioners are also mitigated by the efforts of legislators to limit their authority to noncontentious matters; Commissioners are not to exercise their jurisdiction where contentious issues are being raised, or there are special questions or law or fact, that are more appropriately decided by the court. Still, the *Charities Act* does effectively delegate significant rule-making power to Commissioners. There is an implicit recognition of this in the agency's recent decision to

produce a separate publication to report on Commission decisions "which set precedents" or "signal a change in their [Commissioner's] view of the law."[166] This delegation of significant rule-making power to nonelected officials is of concern in terms of implications for the Rule of Law. It is at odds with a system of administrative law aimed at ensuring that government is "conducted within a framework of recognised rules and principles which restrict discretionary power...."[167]

There is a need to ensure that the important procedural safeguards that exist in a representative democracy are not weakened in efforts to make the machinery of government more efficient and effective. This risk does not arise in connection with the monitoring and investigatory powers of the Charity Commissioners. Our concern relates to the adjudicative power of the Commissioners on matters in which the public interest is not clearly defined in legislation.[168]

One solution, although not an entirely satisfactory one, is to allow substantive questions to be addressed in the courts, as is now done in Ontario and other Canadian provinces. The more appropriate answer is for elected policymakers to come up with a more precise identification of what constitutes the public interest in particular circumstances. This objective can be pursued, in part, by clarifying some of the provisions in primary legislation. Given the need for a flexible legal framework that can be adapted over time to changing circumstances, however, it will be necessary to place much reliance on secondary legislation. While an expert body such as the Charity Commissioners can be expected to play a major role in the identification of needed regulatory changes, the formulation of rules would be subject to political oversight, as distinct from the current approach in the United Kingdom. The regulation-making process provides opportunities for public input and it may include requirements for systematic evaluation.[169] What is of prime importance, however, is that the rules governing charities have the legitimacy that comes from being promulgated by those who are accountable to the electorate.

Another section of the *Charities Act* that raises serious concerns delegates substantial power to local authorities. Charities are required to obtain a permit from a local authority (or an order from the Commissioners) before conducting a charitable appeal in the area under the authority's jurisdiction. As we discuss in the next section, a similar requirement in Alberta was recently struck down by the court – and for good reason.

3.4 The Regulation of Fundraising

The supervision of fundraising is one part of the overall responsibilities of those charged with overseeing the administration of nonprofits. Excessive fundraising costs and improper fundraising practices are one form of poor or negligent administration. Fundraising has become an area of particular public attention and concern, however. A number of jurisdictions, including Alberta and several U.S. states, have introduced special legislation to control charitable solicitation. In the context of the previous discussion, the question that arises is what, if any, controls on fundraising activity should be included as part of an overall framework of laws to govern the supervision of nonprofit activity.

3.4.1 Why Regulate Fundraising?

It is difficult to document the extent of fundraising abuse in Canada. A recent survey found that fundraising costs average 26 percent of the revenue collected by organizations.[170] But while this percentage is seemingly quite reasonable, it is difficult to draw any conclusions from it. For one thing, the average figure hides great disparities between organizations. In a survey of Alberta charities, for example, it was found that those organizations (a small percentage) that relied on outside fundraisers retained a much smaller proportion of campaign proceeds than organizations

conducting their own fundraising.[171] Fundraising costs also depend on the size of the campaign, the nature of the solicitation, whether the appeal is to established or potential new donors, and a range of other factors. Some fundraising events entail higher costs because goods and services (such as a dinner or entertainment) are being provided to donors. High fundraising costs do not necessarily reflect weak cost controls, and low costs do not provide a clear indication of efficient operations.

Public concerns about fundraising stem, in part, from the wide publicity given a number of recent scandals and apparent excesses in charitable solicitation.[172] But what we are also witnessing, in part, is a reaction to the more competitive fundraising environment that has emerged and is characterized by more appeals for charitable donations, and a greater use of professional fundraisers and business methods of campaigning.[173] In addition to addressing problems of fundraising abuse, regulation can serve to allay public concerns and increase public confidence in charitable activities. This would provide important benefits to charities themselves, benefits which they would have difficulty achieving through their own efforts at self-regulation.[174]

The regulation of door-to-door solicitation, direct mail appeals, telephone solicitation, and television campaigns involves consumer protection activities similar to those undertaken by governments in other areas of activity. In the regulation of fundraising, however, governments have attempted not only to protect individual donors but also to protect charities in their role as consumers of services offered by professional fundraisers. In this latter regard, the supervision of fundraising differs somewhat from other aspects of nonprofit supervision that focus exclusively on the fiduciary responsibilities of nonprofit trustees and directors.

3.4.2 Fundraising Controls in the Income Tax Act

There is a general limitation on fundraising costs in the disbursement quota provisions of the *Income Tax Act*. As noted above, these require that fundraising, along with other administrative costs, not exceed 20 percent of the donations for which a charity issued receipts in the previous fiscal year. This requirement, however, is subject to the general limitations of tax-based regulation discussed previously, including, especially its application solely to registered charities. Moreover, the disbursement quota allows organizations considerable room to manoeuvre. It does not prevent charities from incurring exorbitant fundraising costs in particular campaigns. Nor does it preclude very high expenditures in particular years; a charity may apply a disbursement excess against a shortfall in the previous year and up to five of its following taxation years. In addition, the 80 percent disbursement requirement applies only to receipted donations; an organization could spend well over 20 percent of total donations (receipted and unreceipted) on fundraising and satisfy its disbursement quota. The single most important source of revenue for charities, government grants, is excluded in applying the disbursement quota. Hence, if effective fundraising controls are desirable, it is necessary to go beyond the regulations incorporated in the *Income Tax Act*.

3.4.3 The Message of the Courts

In this connection, it is instructive to examine some recent decisions by the courts, and especially the U.S. Supreme Court, which has had much to say about what is appropriate policy in this area. While more than half of the U.S. states had adopted stringent fundraising regulations in the period prior to 1980, since that time, the scope for legislative action has been considerably reduced by three Supreme Court decisions.[175] In *Village of Schaumburg* v. *Citizens for a Better Environment*,[176] the Supreme Court struck down a local ordinance requiring that 75 percent of the funds collected in door-to-door solicitations go to "charitable purposes." The Court found the ordinance interfered with the free speech protection in the

Constitution and that the government's interest in preventing fraud could be served by a more narrowly drawn regulation that did not unnecessarily impact on First Amendment freedoms. The decision noted that the link between high fundraising costs and inefficient or fraudulent behaviour is highly tenuous. It also recognized that fixed limits on fundraising costs discriminate against certain organizations – notably those whose primary purpose was "to gather and disseminate information about and advocate positions on matters of public concern."[177]

In a second case, *Secretary of State* v. *Joseph H. Munson Co.*,[178] the Court ruled that fundraising cost controls are unconstitutional even when they are accompanied by a provision allowing an exemption to organizations that can demonstrate "financial necessity." In striking down the Maryland statute, the Court noted that a "financial" exemption might not take account of a charity's decision to disseminate information as part of its fundraising campaign. In a footnote, the Court highlighted its concern that "by placing discretion in the hands of an official to grant or deny a license, such a statute creates a threat of censorship that by its very existence chills free speech."[179]

In a third decision, the Court ruled against a North Carolina act forbidding fundraisers from charging "excessive or unreasonable" fees,[180] and requiring professional fundraisers to obtain a license and to provide information on fundraising costs to potential donors.[181] The Court offered several reasons why fundraising costs might legitimately exceed the proscribed limits. It took issue with the compulsory disclosure requirements, which would "almost certainly hamper" efforts to solicit donations because the fundraiser is unlikely to be allowed to explain the figure at the door; and which discriminate against small or unpopular charities that are especially dependent on professional fundraisers.

In Canada, a recent decision striking down Alberta's *Public Contributions Act* (PCA),[182] echoes some of the findings of the U.S. courts. The Court of Appeal ruled that, by making it an offence to solicit financial assistance without prior permission of a government or municipal official, the PCA directly impacted on free speech rights contained in the Charter. As in the U.S. cases, it was found that the legislation was overly broad and indiscriminate, and could not be justified by the need to protect consumers. The Court was especially critical of Section 6 of the PCA, which says that "permission may be refused or revoked at any time in the 'discretion' of a government or municipal official,"[183] while providing no objective criteria for the exercise of that discretion. In one municipality, Medicine Hat, the powers provided by the Act had been used to establish especially restrictive conditions for public fundraising campaigns.[184]

These court decisions alert us to how efforts to respond to public concerns about fundraising can lead to regulatory measures involving very high costs. They also point to the questionable benefits from efforts to control fundraising percentages. Fundraising costs are subject to a large number of influences and a particular fundraising percentage is not a reliable indicator of fraud or inefficiency.

With the exception of the restriction in *Riley* on mandatory point-of-solicitation disclosure of fundraising costs, the courts have not argued against enhanced information disclosure. However, the evidence in these cases has helped highlight the difficulty of responding to society's need for improved information. To evaluate the value of their donations, potential contributors need information not only on fundraising but also on the various other activities their donations are going to support. It is useful to know the average expenditures of an organization on fundraising, but there is also a need for information that will help individuals determine the *incremental* impact of their donation on the quantity and quality of various services an organization is providing.[185]

3.4.4 Alberta's New Fundraising Legislation

Following recent court rulings, governments have directed their efforts towards improving the information available to the public about fundraising activities and commercial fundraisers. Alberta's *Charitable Fund-Raising Act* (CFA), the legislation that came into force on May 1, 1995 to replace the PCA, represents one of the more comprehensive of these initiatives. This legislation includes new provincial registration and disclosure requirements for charities and professional fundraisers, and it provides donors with new civil remedies against the improper use of charitable funds.

The CFA requires that fundraisers, organizations using professional fundraisers, and charities that expect to raise $10,000 or more from residents of Alberta, disclose information during the solicitation, in accordance with government regulations. Under current regulations, this includes information on the nature of the fundraiser's payment and the cost of making the solicitation. The relevant charitable organizations are also required to maintain complete records of their operations and annual financial statements. A charity must provide any individual who requests it with copies of their annual financial statement, information on the portion of gross contributions used for charitable purposes, and "reasonable detail" on how the contributions will be spent.

Any organization soliciting contributions of $10,000 or more in Alberta must be registered, and the Minister can refuse registration under the CFA if he has grounds to question the integrity of the charity's principals, directors or managers. Similarly, professional fundraisers must be licensed, and the Minister can refuse to issue a license if a fundraiser has been convicted of an offence or is, for other reasons, judged to be untrustworthy. Charitable organizations that use professional fundraisers must have written agreements that specify all the terms and conditions of the arrangement, including the remuneration of the fundraiser.

Donor fundraisers (i.e., firms who offer to contribute part of the proceeds of their sales to charity) are not required to register, but they are required to respond to requests for information about their charitable contributions. Among the other notable features of the Act are: a provision allowing the Minister to disclose any information obtained under the Act that will contribute to more informed giving; a clause that explicitly prohibits municipalities from regulating or prohibiting charitable solicitations; and a provision that permits any contributor to apply to the Court of Queen's Bench for an order compelling the charity to use its contributions for the purpose stated in its solicitation.

The CFA incorporates a number of features that are needed to protect donors and improve the accountability of charities. As is evident from previous sections, we support those provisions of the CFA which guarantee patrons access to financial statements, annual reports, along with qualitative information about the organization's activities. The legislation is also consistent with our view that charities have an implicit contract with their donors and should be accountable for breaches of that contract. The CFA gives expression to the contractual nature of this arrangement by permitting donors to bring action against an organization that has misused its charitable proceeds. The requirements for registration of charities and licensing and bonding of fundraisers are reasonable measures, similar to those adopted elsewhere to reduce the risk of fraud and dishonesty.[186]

We have some concerns, however, with the point-of-solicitation disclosure requirements in the legislation. Point-of-solicitation disclosure attempts to satisfy individuals' need for readily available summary information that can help them easily assess alternative charitable appeals. It is an attempt to respond to the fact that individuals have little time to devote to information gathering and assessment prior to choosing how to allocate their charitable contributions.[187] In this regard, it is somewhat akin to the labelling requirements that have been mandated for certain consumer products. However, given the lack of time individuals have to invest in research, it is especially important that the summary information made available to them is reliable and meaningful. Information provided at the point of solicitation is

highly influential, and individuals can be made worse off (in terms of their ability to give expression to their preferences) by the provision of inaccurate or misleading information.

Information on fundraising costs and "flow-through" percentages is inherently confusing for the reasons discussed above. In the *Riley* case, the U.S. Supreme Court was correct in warning about the dangers of requiring such information to be disclosed during a solicitation. While it is desirable to work towards the development of meaningful summary indicators of nonprofit performance, it is misleading to suggest that such indicators exist and that the relevant data is among the information being provided to potential donors in the course of an appeal for donations. To avoid any misunderstanding in this regard, the information provided during the solicitation should be restricted to certain basic facts – i.e., the name, address and purpose of the charity; the name, address and credentials of the firm doing the fundraising; and where and how individuals can acquire further information.

In assessing the potential impact of Alberta's new legislation, it is also necessary to understand that officials within the Municipal Affairs department are not in a position to ensure the accuracy of the information charities are required to provide to the public.[188] The benefits of the disclosure provisions of the CFA could be reduced by the incomplete, inaccurate and misleading nature of some of the information that is made available. In terms of fundraising information, for example, recent experience in the United States has demonstrated the need for authorities and the public to be vigilant against fraud and misrepresentation.[189] While it is an offence under the CFA "to make a false statement of fact or misrepresent any fact or circumstance ...,"[190] the legislation is not backed by the type of inspection and investigatory apparatus that encourages confidence in information obtained under the Act.[191]

3.5 A New Approach

The foregoing discussion highlights gaps in existing federal and provincial arrangements for the supervision of nonprofits, and provides guidance on how to design effective policies to close these gaps. The first issue can be seen from another perspective by looking at the sorts of situations that can arise because there is no public agency with appropriate supervisory responsibilities. In the box, we have set out some anecdotal illustrations of these situations, drawn largely from recent legal cases. The bigger problem, as we have emphasized, is that, in the absence of effective supervisory mechanisms, it is more difficult for the sector to build and preserve public trust and confidence. Each situation that is left unaddressed or not satisfactorily resolved undermines public confidence in nonprofit organizations.

In designing a system to close existing gaps, we can learn from the strengths and weaknesses of existing supervisory arrangements. The previous discussion can help us develop a regime that is consistent with the importance of effective fiduciary safeguards and ample information disclosure, two of the main policy considerations identified in Chapter 1; and that, at the same time, complies with the general requirements for good public policy – i.e., to strike an appropriate balance between benefits and costs of supervisory control; to minimize the public and private sector costs incurred to achieve given results; and to respect the requirements of due process and the Rule of Law.

In this section we, first, examine the implications of the previous discussion for the design of a model supervisory mechanism. We then proceed to consider how to give practical expression to this artificial construct. The most serious challenge to the implementation of efficient supervisory arrangements arises from the involvement of multiple governments in nonprofit regulation. The second subsection looks at implementation issues in a federal system and the related problem of how to better coordinate the roles of those administering tax and charity law. In the third subsection, there is a consideration of the role of self-regulation as a complement to, and partial

An Illustration of Problems Arising from the Lack of an Appropriate Supervisory Agency

Scenario 1

John is a member of a national nonprofit organization devoted to environmental concerns. The organization is not a registered charity and has no intention of becoming one. In the name of various environmental causes, it raises money nationally and has attracted a large membership comprised of individuals genuinely concerned about the environment. Lately, he and two other members have become concerned that the national executive of the organization has been misappropriating funds. He has no direct knowledge of this, but when he asked the organization's president for access to the financial statements of the organization, he was denied. In part, his suspicion is based on rumours to the effect that members of the national executive are paid large salaries by the organization and that they have large expense accounts. John does not have sufficient resources to pursue the issue legally and when he called the Office of the Public Trustee in Ontario, where the headquarters of the organization are located, he was told that the Public Trustee's Office had no jurisdiction over nonprofit organizations. He and his friends in the organization feel that the behaviour of the national executive is ultimately going to harm the organization and perhaps environmental causes generally.

Scenario 2

Myriam and six other people are on the board of directors of a registered charity that carries on charitable activity in British Columbia. Lately, she has heard rumours that her organization pays large salaries to its staff, has paid extravagant amounts to professional fundraisers, and is not very efficient or effective in pursuing its fundraising objectives. Recently, several stories have surfaced in the local paper. Myriam and her board of directors meet. They know for a fact that their organization is efficient and effective and they have the means of proving it. Unfortunately, the press is not interested in presenting fairly her organization's side of the story. There is no public agency in British Columbia to which Myriam and her board can go that would be able to quickly audit the organization and stand behind it in denying the false rumours.

Scenario 3

Henry belongs to a national charitable organization devoted to animal welfare. Lately the organization has been taken over by an executive that is highly politicized and activist. The new executive would like the organization to devote a greater proportion of its resources to promoting the adoption of legislation to end the scientific use of animals. Henry stood up at a meeting of the organization last year and objected to the behaviour of the national executive. His interventions were ignored. At that meeting, the president of the organization presented for adoption a motion to amend the letters patent of incorporation to reduce the number of directors on the board. The motion was passed. A smaller number of directors were elected that year, all of them friends of the president. Henry has no one to go to for help.

Scenario 4

Joan has been asked to serve on the board of a nonprofit corporation, which runs a group home in Winnipeg for women in distress. She consults her cousin in London, who is a lawyer, to ask about the legal implications of her accepting the invitation to serve as a director. He tells her the legal situation is a bit confusing and that she might want to see a lawyer who specializes in corporation law. She really cannot afford the services of a lawyer. The handbook her cousin obtained from the Ontario government bookstore states that directors of charitable corporations are "trustees." "What is a "trustee," she wonders. "Is the group home a charity?" Her inability to obtain a clear specification of her legal responsibilities, along with the concerns raised by friends who have had experience on the boards of local charities, leads Joan to decline the invitation.

Scenario 5

Harry works in the policy branch of the Ministry of the Attorney-General in British Columbia. He has heard recently that a prominent charitable organization in Victoria has been receiving government grants, under a matching grant program, based on applications in which costs are claimed to be double their actual amount. He calls the relevant official in the ministry involved to inquire as to their audit procedure. He also contacts the provincial Auditor General's office. Harry learns that there is very little accountability for recipients of government grants. What accountability there is, is located at the ministry level. No recipient has ever been subject to an audit by the provincial Auditor General.

These scenarios are a representative sampling of the problems that can arise where stakeholders and nonprofits themselves do not have an appropriate agency to which they can turn for assistance and support. The result is that problems of accountability and internal governance are more difficult to resolve, rumours and false allegations are less easily put to rest, and individuals attempting to enforce legislation, or simply to understand their rights and obligations under nonprofit law, must generally do so at their own expense.

An Illustration of Problems Arising from the Lack of an Appropriate Supervisory Agency (cont'd)

Notes: Scenario 1: see *Re Faith Haven Bible Training Centre* (1988), 29 E.T.D. Scenario 2: see P. Starr, *Tempting Fate: A Cautionary Tale of Power and Politics* (Toronto: Stoddart, 1993). Scenario 3: see *Re Public Trustee and Toronto Humane Society et al.* (1987), 60 O.R. (2d) 236 (H.C.). Scenario 4: See *Re Laidlaw Foundation* (1984), 48 O.R. (2d) 549, 18 E.T.R. 77 (Div. Ct.). Also *Re Harold G. fox Education Fund et al. and Public Trustee* (1989), 69 O.R. (2d) 742 (H.C.). Scenario 5: See *Humane Society* case cited above and newspaper reports on the Patricia Starr affair. The Charity Commissioners for England and Wales frequently address problems of the type indicated by scenarios 2 and 3.

substitute for, government supervision. This discussion gives recognition to the importance of efficiently utilizing all resources, public and private, that are available to promote improved administrative practices and better accountability in nonprofits.

3.5.1 A Model Regime

Consider the characteristics of a supervisory regime that incorporates the desirable features, and excludes the undesirable elements, of those agencies we have examined. All nonprofits would come within the purview of the proposed supervisory agency (hereafter "the Agency"). The limitations in governance arrangements that provide a rationale for public oversight are a potential problem in trusts, charitable corporations, and nonprofit associations. This is not to suggest that concerns apply equally in all areas. One might expect that in dealing with associations, for example, the Agency would primarily focus its attention on the relatively few organizations that have substantial assets and/or revenues and a large base of passive members that could use assistance overseeing administration. The Agency would have a minimal role with respect to those organizations where members might be expected to be able to look after their own interests.

The role of the Agency would also decline where nonprofits are being overseen by other branches of government. In the case of hospitals and universities, for example, there would be a need to coordinate the activities of the Agency with those of the relevant provincial government departments. This could lead to a sharing of responsibilities or result in the complete exemption of such organizations from the requirements imposed by the Agency. Initially, however, the Agency's jurisdiction should be sufficiently broad that it could address improprieties in all types of nonprofit organizations. Differences among organizations, including differences in both type and size, can then be taken into account by modifying reporting requirements and appropriately focusing the Agency's supervisory activities.

The role of the Agency would be to enforce the fiduciary obligations of trustees, directors and managers, as these are specified in relevant legislation and any accompanying regulations, and to generally promote the efficient use of nonprofit resources. An important part of the Agency's activities would involve providing information and advice to encourage the development of better administrative practices and stronger accountability structures.

In overseeing nonprofits, the Agency would perform many of the same functions as existing supervisory agencies. Like the English Commission and the Ontario Public Trustee, it would attempt to ensure that charitable gifts are being properly applied by those with responsibility for administering the property. This requires that there is a record of those holding charitable property through a gift or bequest. As in Ontario, the supervisory Agency is likely to devote particular attention to those charitable gifts in which there is no specific beneficiary to enforce the terms of the will or other instrument.

In the Agency's general oversight of operating nonprofits, there would be an emphasis on two requirements that are crucial in promoting accountability and protecting patrons' interests: the need for nonprofits to commit themselves to reasonably well-

defined objectives; and the need for disclosure of the quantitative and qualitative information patrons require to understand how these objectives are being pursued. Aside from ensuring there are no abuses, the Agency would devote much of its monitoring efforts to encouraging the satisfaction of these requirements. In helping organizations properly define their objectives, the Commission would largely play an educational and advocacy role. It could, however, bring action against directors and managers that were seen to be disregarding the objectives specified in the organization's governing documents.[192] The Commission would promote information disclosure by helping to develop regulations that establish appropriate reporting requirements for nonprofits.

Organizations below a certain size threshold would be allowed to submit unaudited and somewhat less detailed reports, but, in all cases, organizations would be required to provide more adequate information than is currently available through Revenue Canada's Public Information Return. The submitted documents would clearly specify the organization's objectives, and it would include information that would help individuals understand how their contributions and revenues from other sources are being disbursed to cover fundraising and other administrative expenses, and to increase the quantity and/or improve the quality of services delivered in various areas. Any of the organization's transactions in which controlling persons had an interest would also need to be fully disclosed. Some of the required information could be conveyed through a trustee's report, similar to that issued by charities in England and Wales. The public would be able to obtain copies of all documents from the agency or directly from the organizations (which would be permitted to impose a minor charge to cover distribution costs).

Charities would not be asked to meet special registration requirements for fundraising, but, as part of their reporting requirements, they would be required to inform the public about their fundraising activities and practices, along with the expenses incurred. At the point-of-solicitation, fundraisers would be required to identify themselves and their cause, but not to disclose fundraising costs or other financial information. Professional fundraisers, however, would be required to obtain licenses and become bonded, as under Alberta law. The latter are not very restrictive (and, hence, not very costly) requirements, and they would provide a measure of protection to both donors and charitable nonprofits.

While public complaints and leads from other government bodies would help identify potential problems, the Agency would undertake its own monitoring based on random checks and the auditing of submitted financial reports. In regard to the latter function, the Agency could learn from the English Charity Commission's efforts to computerize its data systems and develop indicators that can flag those organizations whose activities merit closer review. As with the Commission, the objective would be to establish an early warning system and help directors and trustees address issues before they become serious concerns.

To facilitate the investigation of possible problems, the Agency would have the power to subpoena documents and examine organization records on site. It would not have the powers of the Charity Commissioners of England and Wales to suspend directors, appoint a new manager or issue other remedial orders, although, it could use the findings from its investigations to press for the satisfactory out-of-court resolution of problems.

The scheme-making and cy-pres powers of the Charity Commissioners have added some useful flexibility to English policy, but the exercise of such wide authority by administrators does entail costs. While it is desirable to build in a process whereby trustees and directors can apply for an amendment in the substance of a charity or the rules governing its administration, it is important to ensure this does not result in an inappropriate delegation of discretionary powers. The supervisory Agency should be in a position to assist trustees and directors who are unnecessarily restricted in operating a charity, but its decisions should be based on regulations that define the public interest in some detail and indicate the criteria to be applied in particular circumstances.[193] We would not propose that the Agency be given the

powers of the Charity Commissioners to proceed on its own initiative where trustees and directors have not applied for a scheme. Moreover, the Agency should not be allowed to exercise its scheme-making authority where applications raise major new and potentially contentious issues that have not been anticipated in existing regulations. These matters would be decided by the courts, which would also adjudicate appeals of Agency rulings.

3.5.2 Supervision in a Federal System

The functions of our proposed Agency could be allocated among federal and provincial departments that currently have some supervisory responsibilities or it could serve as a model for a single federal-provincial nonprofit agency. Whatever approach is pursued, there is a need for mechanisms to avoid duplication, and to allow realization of the economies from a cooperative approach.

While it is sometimes desirable to encourage experimentation with diverse policy approaches, the benefits from diversity are likely to be minimal in the area of nonprofit supervision. Supervisory requirements do not differ significantly across provinces and communities. And this is not a policy area in which we are likely to witness competition among governments attempting to come up with more cost-effective methods of program delivery. What is far more apparent are the costs to governments of operating uncoordinated and partially overlapping systems; and the added costs to individual organizations in terms of increased uncertainty and higher compliance costs.

Cooperation aimed at reducing conflict and overlap among Canadian governments has traditionally taken one of two forms: the establishment of mechanisms to promote a coordinated approach by all governments, and the delegation of administrative responsibilities by one level of government to another. Both alternatives deserve consideration as a solution to the current patchwork system of nonprofit policymaking and supervision. While there is room for debate about which approach is most compatible with the allocation of interests among the provinces and the federal governments, either alternative would involve a significant improvement over the existing situation.

3.5.2.1 Intergovernmental Coordination

A number of existing mechanisms and agreements serve as useful examples of intergovernmental coordination. The Agreement on Internal Trade, signed by the federal, provincial and territorial governments in July 1994, is a significant, albeit limited, demonstration of collaboration aimed at generally addressing problems arising from the existence of multiple, and sometimes conflicting, regulatory standards within the Canadian economic union.[194] At the sectoral level, intergovernmental coordination has occurred through numerous federal-provincial conferences and agreements. In agriculture, for example, federal and provincial governments have made progress in working towards the adoption of common standards with respect to products and product grades, plant and animal health regulations and transportation requirements. In the environmental area, cooperative arrangements are being developed through the efforts of the Canadian Council of Ministers of the Environment, an ongoing forum that meets twice annually and is served by a permanent secretariat.

A coordinated policy approach towards nonprofits requires intergovernmental agreements to be worked out in a number of areas. First, there is a need for agreement on a uniform set of legal standards to govern the organization of nonprofits. We believe Chapter 2 provides a starting point for the development of model legislation that could be adopted by all jurisdictions in Canada. Second, there is a need for an arrangement whereby all jurisdictions would come to a common understanding of the relevant common law. In particular, there is a need for governments to apply a common set of criteria in determining what constitutes charitable activity. Third, governments must establish a single set of reporting and disclosure requirements for nonprofits – ideally, reflecting the importance of adequate disclosure, as discussed in the

previous section. And fourth, the division of administrative and supervisory requirements must be clarified. This requires that the current system, in which organizations operating in different provinces may be subject to a number supervisory regimes, be replaced by an arrangement that results in the establishment of a lead agency. For those entities under its ambit, the lead department or agency could fill the needed support and advisory role, as well as undertaking the required monitoring and oversight.

An efficient system for allocating responsibilities must make use of the significant resources that Revenue Canada devotes to the supervision of nonprofit, and especially charitable, activities. Existing Revenue Canada requirements for reporting and information disclosure provide a useful base for building the reporting system that is needed to promote improved accountability. The monitoring capacity Revenue Canada already has in place would also need to be integrated into a coordinated arrangement. This could be achieved by reducing Revenue Canada's monitoring activities in those provinces where governments are willing to undertake the required supervision of nonprofits. In these provinces, the responsibility of ensuring full and accurate reporting would now fall to provincial supervisory agencies. The tax authorities could place greater confidence in the information filed by nonprofits in these jurisdictions, knowing that it was subject to a separate process of oversight. Provinces may choose, however, to have the federal government perform the required supervisory functions in their jurisdiction and, where it has lead responsibility, it would be reasonable for the federal government to draw upon the resources and experience of Revenue Canada.

A coordinated approach would ideally result in the application of the same criteria provincially, to give legal recognition to "public benefit" and "religious" organizations (as charities would be classified under the proposals in Chapter 2), and, federally, to determine whether an organization qualifies for charitable status under tax law. This would require a significant degree of accommodation by both levels of government. It would also require a process that allowed for intergovernmental deliberations on important decisions that affected the way court rulings on the definition of charity are interpreted.

Cooperation could be achieved through various institutional arrangements. It is possible to envisage a forum, akin to that in the environmental area, which would regularly bring federal and provincial representatives together to deliberate on important issues affecting the application of framework laws to the sector. This could be supplemented by intergovernmental agreements specifying the allocation and sharing of supervisory responsibilities. An instructive example of cooperative agreements are the administrative and equivalency agreements recently negotiated by environmental ministers, which allow industries to satisfy all regulatory requirements in specific areas through one level of government.[195]

3.5.2.2 A National Nonprofit Agency

Under this option, a national nonprofit agency would assume the functions proposed for our "model" supervisory regime. It would provide information and advice to nonprofits; establish information and disclosure requirements; and undertake the required monitoring of nonprofit activities, along with the investigation of questionable practices.

While the determination of which organizations qualify for charitable status and for "nonprofit" status under tax law falls outside the nonprofit commission's interest in preventing abuse and promoting better administration, there are strong complementarities between these activities. There is merit in following the English example and using the commission's expertise and its information gathering resources to establish a central organizational register. This could be used to identify those organizations qualifying for tax preferences, and it might also serve as the basis for classifying organizations by purpose under organizational law. If the nonprofit commission is to have the main responsibility for classifying organizations, however, it is important that an acceptable decision-making process is in place. Concerns

about the discretionary power of the commission would be reduced if its decisions were governed by regulations that helped define "public benefit charities," "religious" organizations and other nonprofits. Ideally, these regulations would be developed through a process of intergovernmental consultations, and represent the consensus among federal and provincial decision makers. In addition, there should be an opportunity for interested parties, including governments, to intervene in support of, or opposition to, particular applications for nonprofit and charitable registration. And the commission should be required to publicize the reason for its decisions in significant cases that amplify or modify the interpretation of regulations.

A national nonprofit commission is likely to have some advantages over the alternative of a coordinated approach involving different federal and provincial supervisory organizations. A single agency would be able to more fully exploit available administrative economies. In particular, sophisticated centralized information systems and specialized expertise would allow a central agency to realize economies in excess of those that could be achieved through a coordinated approach. Compliance costs to organizations would also be reduced. While a coordinated policy approach would help eliminate conflicting policies, the establishment of a single agency would contribute to a still more stable policy environment. With a nonprofit commission, all organizations would be subject to a clear set of administrative requirements, and have a single window to which they could turn for assistance and advice.

One of the main advantages of a national commission is that this institutional arrangement is likely to allow for a more complete integration of supervisory activities with Revenue Canada's monitoring and enforcement activities in the nonprofit area. The functions that we have proposed for a national commission overlap to a considerable degree with the monitoring and enforcement activities currently carried out by Revenue Canada. Like the Charities Division, the proposed nonprofit commission would: register charities; establish reporting requirements and monitor financial and other returns to ensure full and honest reporting; and encourage the establishment of improved financial controls and better reporting systems. As a respected body that reports to Parliament through a federal minister but that is also part of a consultative process through which the provinces are able to input into selected areas of nonprofit policymaking, the commission could be entrusted with most of Revenue Canada's current responsibilities in these areas. Indeed, it is possible to envisage most of the resources of Revenue Canada's Charities Division being transferred to the commission and forming the core of the new supervisory organization.

The establishment of a national nonprofit commission would require the provinces to accept federal decision making in some areas under provincial jurisdiction. Some essentially local activities, such as the enforcement of wills, could conceivably be retained at the provincial level, but a national agency would not be feasible unless the provinces are prepared to delegate most of their supervisory responsibilities to the federal government. While there are precedents for this delegation "upwards" of administrative responsibilities – one of the most notable examples being the federal/provincial tax collection agreements, which provide for federal collection of personal and corporate income taxes on behalf of the provinces – the proposal to establish a national nonprofit commission seems to run counter to the current trend towards devolving responsibilities downwards. The provinces, however, have not invested significant resources in the supervision of nonprofit activities. Nonprofit supervision differs in this sense from other areas of provincial government activity in which there are established interests with a significant stake in the existing system. The proposed commission would rationalize administration by transferring most responsibilities to the jurisdiction that has the largest interest in nonprofit supervision and accounts for the major portion of resources committed to this activity.

3.5.3 Coordination between Public Supervision and Self-Regulation

Under a system of self-regulation, bodies representing nonprofits, or specific subgroups of nonprofits, would establish prescribed codes of behaviour and attempt to ensure their members adhere to these requirements. Self-regulation attempts to harness the interests of organizations in preventing fraudulent and misleading practices that can damage the reputation of the sector as a whole. In the case of charities, organizations have a strong self-interest in preventing scandals that can undermine public confidence and reduce charitable contributions generally.

Self-regulation draws on the expertise of those in the sector to establish appropriate standards of conduct. Moreover, the resulting controls are more flexible than government laws and regulations, and can be more easily adapted to take account of new circumstances and address new problems. From the government's perspective, self-regulation is attractive because the costs are borne by the sector; there is the possibility of shifting resources from nonprofit supervision to other public sector activities.

However, associations have no power to enforce their codes of behaviour. They cannot compel eligible nonprofits to become members of the association, and they cannot impose any significant sanctions on members who do not adhere to the prescribed rules.[196] When associations have a small number of members who are well acquainted with one another and infractions can be quickly identified, peer pressure can be influential.[197] But in sectors with a large number of diverse organizations, it is very difficult to establish rules that are acceptable to all participants and likely to achieve a high degree of voluntary compliance.[198]

While the limitations of voluntary codes need to be understood, it is also important to be open to the contribution nonprofit associations can make to the development of improved management practices and increased accountability. The contribution of the sector is potentially important partly because of the limited resources governments can devote to supervisory activities. In addition, the development of the performance measures and program assessments, which are the underpinnings of a true accountability framework, is ultimately dependent on the efforts of the sector itself, and independent groups that are overseeing the sector on behalf of stakeholders.[199] Governments cannot legislate and enforce the development of the specific performance measures that stakeholders require to be able to assess and compare the outcomes of various organizational activities.

Aside from supporting the efforts of the nonprofit sector to develop behaviourial codes and self-enforcement mechanisms, governments should be open to opportunities to coordinate public sector supervision with the initiatives undertaken by the sector itself. An instructive example of how to proceed is provided by Treasury Board guidelines pertaining to the development of federal regulations. Departments are explicitly encouraged to take account of the existence of voluntary industry standards in designing their regulatory compliance and enforcement strategies. Treasury Board has specifically pointed to the advantages, from a regulatory perspective, when firms are registered as meeting ISO 9000 standards.[200] Firms that have been certified by an accredited standards organization as meeting ISO 9000 standards have put in place quality control systems that satisfy internationally recognized objectives. Where this important quality check is in place, it is recognized that there is less need for monitoring to ensure that firms comply with government regulatory requirements.

It is possible to envisage a somewhat similar approach in the nonprofit sector. Organizations that have implemented appropriate management controls and complied with specific reporting and information disclosure requirements could be certified by an independent body. The public sector supervisory agency could reduce its monitoring of certified organizations and devote increased attention to other, potentially more problematic organizations.

The establishment of a credible certification system, however, is a significant challenge. The certification process in the for-profit sector is based on standards that have been developed over a period of time and gradually gained international recognition. The certification is undertaken by independent bodies that

represent both producers and users, and that have, themselves, been subject to a process of accreditation.[201] In addition, government departments periodically audit the ISO system to ensure that registered firms do satisfy government regulatory requirements. Considerable effort is needed to develop a process of self-regulation for the nonprofit sector that could similarly instill a high degree of public confidence and thereby justify a relaxation in government supervisory activities.

4 Conclusions

Our analysis has highlighted major shortcomings in the existing framework of organizational and supervisory laws: current laws do not adequately enhance or enable activity in the sector; they do not provide the clear, stringent fiduciary safeguards that are needed to encourage public confidence in nonprofit activities; they do not provide the information disclosure that is necessary to promote effective participation by stakeholders and accountability by nonprofit controllers; and they do not work in unison to establish a clear, coherent regulatory environment that minimizes uncertainty and economizes on the resources required for administration and for compliance. Our proposals for the major reform of nonprofit organizational and supervisory laws would address each of these shortcomings.

More Enabling Laws

Our proposals will enhance the enabling features of organizational law in a number of ways. First, they will result in the elimination of some undesirable restrictions that are a part of existing law and administrative practice. For example, we propose: the elimination of the requirement that charities apply for approval of letters patent of incorporation; the introduction of legislative changes to eliminate the impediments faced by unincorporated associations as a consequence of their lack of civil capacity; and the relaxation of current costly restrictions on the investment and borrowing powers of charitable fiduciaries.

Second, the proposed reforms would include a broad range of suppletive laws that organizations can tailor to their specific needs. The framework we are proposing would provide some much needed guidance to nonprofit founders on the legal status of members and other matters of internal governance. Issues that are not adequately covered under current legislation, such as the governance appropriate to national nonprofits with regional or provincial chapters, would be addressed under the more comprehensive statutes we are proposing.

Third, we have proposed the reform of government supervisory activities so that part of the responsibilities of those overseeing the sector is to assist and inform nonprofit participants. The relevant commission or agencies would help nonprofit participants understand and comply with their obligations, and encourage high standards of corporate governance. Government would also encourage and support the efforts of nonprofits to develop their own supervisory mechanisms.

Improved Fiduciary Safeguards

Our proposals would remedy the current ambiguity regarding the obligation of nonprofit fiduciaries by legislating clear, reasonably stringent, standards. Fiduciaries would be required to meet a standard of due diligence (the duty of care), and to act honestly and faithfully in the best interests of the organization (the duty of loyalty). In public benefit, religious and private nonprofits, where there are no members to oversee the activities of the management and board, there would be strict controls that prevent fiduciaries from gaining financially from their position. As well, members, along with other nonprofit stakeholders, would have the right to sue fiduciaries derivatively.

Improved reporting and monitoring would help to ensure fiduciaries comply with their obligations. To

strengthen the influence of nonprofit supervisory agencies, we have proposed that they have the same rights as members to sue fiduciaries who are in breach of their duties.

Improved Information Disclosure

Under our proposals, nonprofits would be more accountable because of requirements for improved information disclosure. Since stakeholders would be better informed, their choices, and their "exit" decisions in particular, would become a more reliable indicator of the ability of nonprofits to satisfy public preferences and expectations.

Improved information disclosure would be achieved, under the regime we are proposing, through the regulatory-development, educational, and monitoring activities of nonprofit supervisors. Regulations would address the need of stakeholders to have more ample information than is currently available from Revenue Canada's Public Information Return. While somewhat lower requirements would be imposed on smaller organizations, the general intent would be to provide stakeholders with a clear picture of the activities, resources and outputs of nonprofit organizations. Nonprofit supervisors would, at the same time, undertake the auditing and monitoring that is necessary to ensure the reliability of the information that is publicly disclosed.

Along with adequate reporting, an effective system of accountability requires that organizational objectives are clearly specified. A major focus of the supervisory agencies's educational activities would be on helping nonprofits to precisely formulate their objectives. Nonprofits would be encouraged to specify objectives so that stakeholders understand clearly what the organization is attempting to achieve and the development of performance measures becomes feasible.

A Clear, Coherent Legislative Framework

A major contribution of our proposals would be to provide some much needed clarity and certainty to the legal environment within which nonprofits operate. This would result partly from the establishment of clear legislative standards on important issues that have not been adequately addressed through existing legislation or through common law. Clarity would also result from our proposal that common standards be adopted by all jurisdictions. The benefits that are available from legislative experimentation at the provincial level are likely to be far outweighed by the increased clarity and certainty that would accompany the establishment of a common legislative code by all provinces.

In addition, our proposals would bring order to the system by coordinating the administration and enforcement of nonprofit legislation. Coordination can be achieved by mechanisms that allow jurisdictions to share information and rationally divide up supervisory responsibilities, or alternatively by consolidating responsibilities for the enforcement of nonprofit legislation in a new agency. Under both approaches, there would be an attempt to integrate nonprofit oversight with the supervision undertaken in the administration of tax legislation. There would also be recognition of the contribution that the sector can make through its own supervisory activities. In allocating resources, government agencies would take account of the reduced requirements for oversight in those components of the sector that are subject to an effective system of self-regulation.

With the establishment of a national nonprofit commission, organizations would be subject to a single set of administrative requirements, and nonprofit participants would have a single window to which they could turn for advice or to voice their concerns. However, either the establishment of a commission or the development of mechanisms of intergovernmental cooperation would contribute to more efficient and effective public sector involvement. The proposed reforms would lead to more even and effective supervision than currently exists. They would also result in reformed public agencies that have the mandate and resources to educate the sector and promote improved administrative practices. Our proposals for institutional reform complement our recommendations for legislative reform, and re-

emphasize the need for a fundamental overhaul of government policies towards the nonprofit sector.

Federal and provincial organizational laws fall far short of their goal. The current picture is more one of valuable social activity occurring in spite of the law that was meant to encourage and enhance it, not because of it. At this point in time, where the third sector is being increasingly called upon to fill gaps in the system and provide new social services, the inadequacies of the legal framework are especially apparent. Reform is needed, we think urgently, to produce a set of organizational and supervisory laws that are balanced, responsive, clear and coherent.

Notes

1 This right is clearest in clubs or mutual organizations where members elect the board of directors. In other organizations, major donors and/or stakeholders who helped found the organization may be represented on the board and accorded an important role in setting organizational objectives and strategies.

2 There are exceptions. In some mutuals, membership interests are transferable.

3 While these differences in property rights are given recognition and support by the state and could be changed by legislation, we do not explore this possibility. Implicit in our definition is the recognition that existing legal restrictions on nonprofit surplus distribution have special significance, and, therefore, are different from other aspects of nonprofit law that are legitimately subject to review.

4 This draws on Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press, 1991.)

5 For example, Roberta Romano, "Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws," *Columbia Law Review* 89, 1989; and Oliver Hart, "Corporate Governance: Some Theory and Implications," *The Economic Journal*, May 1995.

6 While shareholders must approve amendments to the corporation's charter, it may be possible for a change that is adverse to the interests of shareholders to gain passage because of collective action problems. See Jeffrey N. Gordon, "The Mandatory Structure of Corporate Law," *Columbia Law Review* 89, 1989.

7 The potential significance of political constraints are highlighted in Burton A. Weisbrod, "Towards a Theory of the Voluntary Nonprofit Sector in a Three Sector Economy," in E. Phelps (ed.), *Altruism, Morality and Economic Theory* (New York: Russell Sage Foundation, 1975). Public Sector rigidities are discussed in S. Rose-Ackerman, *Rethinking the Progressive Agenda: The Reform of the American Regulatory State* (New York: Free Press, 1992).

8 This is part of a larger theory of contract failure developed in Henry Hansmann, "The Role of Non-Profit Enterprise," *Yale Law Journal*, November 1980.

9 The role of nonprofits in fostering the development of a nation's social capital is discussed further in Section 1.5.

10 The "agency costs" that are of concern have been defined by Michael Jensen and William Meckling to include the sum of: monitoring expenditures by the principal; "bonding" expenditures incurred by the agent to guarantee that he will not take certain actions to harm the principal; and the "residual loss" that results because it is not possible to fully align the interests of principals and agents. M.C. Jensen and W.H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure," *Journal of Financial Economics* 3, 1976.

11 More specifically, it is the "residual" status of shareholders that is of significance. Shareholders have a claim to what is left over after all obligations to management, labour, suppliers, lenders and their creditors have been paid. As a consequence, shareholders have a strong incentive to see that management takes those decisions that are most likely to maximize corporate wealth.

12 In Canada, the operation of market controls is partly strengthened and partly complicated by the fact that (in contrast to the United States) most large firms are closely held. The existence of a dominant stakeholder facilitates the monitoring of corporate performance, but gives rise to concerns that decisions may be made that are contrary to the interests of minority shareholders. In addition, dominant stakeholders may

become entrenched, thereby undermining the operation of takeover markets. This is discussed in Ronald J. Daniels and Randall Morck, *Corporate Decision-Making in Canada*, (Calgary: University of Calgary Press, 1995).

13 Oliver Williamson has observed that beneficiaries "are among those who stand to lose the most if nonprofits are badly run," and who can thereby "be said to have residual claimant status." While there is a case for including intended beneficiaries on the board of directors, Williamson recognizes the potential for conflicts of interest, "which include but are not restricted to possible neglect of the interests of future generations." Oliver Williamson, "Organizational Form, Residual Claimants, and Corporate Control," *The Journal of Law and Economics*, June 1983, p. 358.

14 Frank H. Easterbrook and Daniel R. Fischel, "Contract and Fiduciary Duty," *Journal of Law and Economics*, April 1993.

15 The "business judgement" doctrine, which applies in the United States but has also been influential in Canada, reflects the court's reluctance to second-guess management. As a consequence, while the fiduciary principle can prevent certain flagrant attempts to use corporate resources for personal gain, it does not impose any pressure on directors and managers to pursue corporate objectives efficiently. Easterbrook and Fischel, ibid.

16 This is discussed in John Posnett and Todd Sandler, "Transfers, Transaction Costs and Charitable Intermediaries," *International Review of Law and Economics*, December 1988.

17 While common funds reduce the choice of individual contributors and reduce the direct pressure on charities to satisfy donor expectations, they offer potentially offsetting advantages. Common funds may establish a type of internal market in which organizations compete on the basis of established criteria. In addition, a common fund is likely to offer significant savings in the overall resources devoted to fundraising. The latter is discussed in S. Rose-Ackerman, "Charitable Giving and Excessive Fund-raising," *Quarterly Journal of Economics* 97, 1982.

18 It is rational for individual donors to remain largely "ignorant," since the costs of gaining and assessing information about nonprofit activities are likely to exceed the benefits from being a better informed stakeholder. While all stakeholders, as a group, have a strong interest in becoming better informed, the costs of collective action are generally prohibitive.

19 Most members, however, may be "free riders" and have little or no influence on the operations of the organization. Hence the activities of the organization may aim at satisfying a subset of very active members, rather than maximizing benefits for all members.

20 The exercise of control by some patrons provides a signal of "high quality" to other patrons. This is especially so if the service being produced has important aspects of nonrivalry. The latter increases the likelihood that benefits of the service will be available to all patrons, and reduces the risk that production will be slanted to provide greater benefits to the controlling patrons. This is discussed in A. Ben-Ner and T. Van Hoomissen, "The Nonprofit Sector in the Mixed Economy," *Annals of Public and Cooperative Economics* 62(4), 1993.

21 Robert D. Putnam, *Making Democracy Work: Civic Traditions in Modern Italy*, (Princeton: Princeton University Press, 1993). Also, John F. Helliwell and Robert D. Putnam, "Social Capital and Economic Growth in Italy," *Eastern Economic Journal* 21(3), 1995.

22 This justification for nonprofits and its implications for organizational law are a major theme in H. Hansmann, "Reforming Nonprofit Corporation law," *University of Pennsylvania law Review* 129, 1981.

23 This is based on the well-known study by Albert O. Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations and States*, (Boston, Mass.: Harvard University Press, 1970).

24 The failure of democracy in widely-held U.S. corporations is discussed in Edward J. Epstein, *Who Owns the Corporation? – Management vs. Shareholders*, (New York: Twentieth Century Fund – Priority Press Publications, 1986).

25 See: B.C. *Society Act* R.S.B.C. 1979, c. 390; *Code civil du Québec*, articles 2267 to 2279; *Non-Profit Corporations Act, 1995*, S.S. 1995, C.N-4.2.

26 See, for example, *Corporations Act* R.S.O. 1990, c. C-38; *Canada Corporations Act*, R.S.C. 1970, c. C-32; *Companies Act*, L.R.Q. 1977, c. C-38.

27 See J. Ziegel et al., *Cases and Materials on Partnerships and Canadian Business Corporations* (Toronto: Carswell, 1994), ch. 6, 7 and 8.

28 Anglo-Canadian law establishes a categorical distinction between "charity" and a noncharity. The distinction is used to determine the validity of purpose trusts. Only purpose trusts with charitable purposes are valid. The jurisprudence on the meaning of "charity," therefore, is of central importance in the law of purpose trusts. In its modern form, it dates back to the beginning of the 19th century and the famous case of *Morice* v. *Bishop of Durham* (1804) 9 Ves 399, 32 E.R. 656; aff'd (1805) 10 Ves 522, 32 E.R. 947. "Charity," according to that jurisprudence, has a special "legal" sense. In *The Commissioners for Special Purposes of the Income Tax Act* v. *Pemsel*, [1891] A.C. 531, the leading modern case, Lord MacNaghten said:

> Of all words in the English language bearing a popular as well as a legal signification, I am not sure that there is one which more unmistakeably has a technical meaning in the strictest sense of the term, that is a meaning clear and distinct, peculiar to the law as un-derstood and administered in this country, and not depending upon or coterminous with the popular or vulgar use of the word. (p. 581-582)

Lord MacNaghten defined it as follows:

> "Charity" in its legal sense comprises four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community....

29 *Interim Report of the Select Committee on Company Law* (Toronto: Legislative Assembly of Ontario, 1967).

30 Ibid.

31 When the 31st parliament was prorogued.

32 See Institute of Law Research and Reform, *Proposals for a New Alberta Incorporated Associations Act* (March, 1987); Bill 54 *Volunteer Incorporations Act*, 2d Sess., 21st Leg. Alta., 1987; and The Volunteer Incorporations Act Task Force, *Toward New Non-Profit Legislation: Report of the Task Force on the Volunteer Incorporations Act* (1990).

33 Ontario Law Reform Commission, *Report on the Law of Trusts* (Toronto: Ministry of the Attorney General, 1984).

34 There was a proposal to relax the cy-pres doctrine, a proposal dealing with imperfect trusts, and a proposal dealing with the unexpended funds of a public appeal.

35 See Law Reform Commission of British Columbia, *Working Paper on Non-Charitable Purpose Trusts* (1991) and *Report on Non-Charitable Purpose Trusts* (1992), and Manitoba Law Reform Commission, *Non-Charitable Purpose Trusts* (1992).

36 See Law Reform Commission of British Columbia, *Consultation Paper on Conflict of Interest: Directors and Societies* (1993), and *Report on Informal Public Appeals* (1993).

37 See *supra*, note 25.

38 Ibid.

39 Ibid.

40 Alternatively, it is possible that one particularly thoughtful legislative model proposed by and adopted in one jurisdiction, might be adopted in several. This is what happened with the *Canada Business Corporation Act*, R.S.C. 1985, c. C-44, the *Ontario Securities Act*, R.S.O. 1990, c. S-5 and, to some extent, the personal property security regimes in Canada.

41 This is the method used by the American Law Institute and American Bar Association with their "model acts."

42 See *Re Faith Haven Bible Training Centre* (1988), 29 E.T.R. 198 (Ont. Surr. Ct.); *Re David Feldman Charitable Foundation* (1987), 58 O.R. (2d) 626 (Ont. Surr. Ct.); *Re Harold G. Fox Education Fund*

et al. and Public Trustee (1989), 69 O.R. (2d) 742 (H.C.); *Re Centenary Hospital Association and Public Trustee*, (1989) 69 O.R. (2d) 1(H.C.); *Re Public Trustee and Toronto Humane Society et al.* (1987), 60 O.R. (2d) 236 (Ont. H.C.) [hereinafter, *Toronto Humane Society*]; *Re Incorporated Synod of the Diocese of Toronto and HCC Hotels Ltd. et al.* (1987), 61 O.R. (2d) 737 (C.A.). Other jurisdictions dealt with similar concerns. See *Roman Catholic Archiepiscopal Corp. of Winnipeg* v. *Ryan* (1957), 12 D.L.R. (2d) 23 (B.C.C.A.); *Re French Protestant Hospital* and *Attorney General*, [1951] 1 All E.R. 938 (Ch); and *Liverpool and District Hospital for Diseases of the Heart* v. *Attorney General*, [1981] 1 Ch. 193.

43 Directors' remuneration is only one of several issues. Another is the legality of a charitable foundation being devoted exclusively to fundraising for charity. The Office of the Public Trustee has stated publicly on several occasions that fundraising by itself is not a charitable activity and that, therefore, foundations devoted exclusively to fundraising are unlawful:

> Fundraising is not of itself a charitable purpose. It is however permissible as one of the incidental and ancillary powers of a charity. Where the fundraising activities of the charity become a primary purpose, or where the fundraising becomes a means of providing a livelihood for members, serious concerns arise as to whether the organization is in fact established and operating exclusively for purposes charitable in law.

See Office of the Public Trustee and Ministry of Consumer and Commercial Relations, Ontario, *Not-For-Profit Incorporator's Handbook* (Toronto: Queen's Printer, 1989) at 69 [hereinafter *Handbook*].

Still another is the capacity of a charity to own land it does not use for its operations. See *Re Centenary Hospital Association and Public Trustee*, *supra*, note 42.

44 The Office of the Public Trustee has set out its views in *Handbook*, *supra*, note 43. The *Handbook* provides at p. 63-4 that directors of charitable corporations are trustees:

> Although directors technically speaking run corporations while trustees administer trusts, the law of trusts concerning charitable purpose trusts and property is also applied to incorporated charities so far as the responsibility of directors and officers for the administration and management of an incorporated charity's property is concerned.

And that therefore they may not be paid any remuneration without prior court approval:

> The general rule is that the charity shall not pay any remuneration to a trustee in any capacity whatsoever unless court approval is first obtained. Trustees are however empowered to receive payment out of the charity's property for reasonable and necessary out-of-pocket disbursements. The trustees furthermore should not benefit either directly or indirectly from any transaction with the charity.

Nor may they deal in any other way with the charity without such prior approval:

> Under very special and exceptional circumstances, the Court can authorize a non-arms length transaction between a trustee and the charity provided that the trustee seeks the court's approval with full disclosure and due notice to the public trustee before the transaction is completed.

See, also, Public Trustee for Ontario, "Submissions to the Ontario Law Reform Commission: Project on the Law of Charities" (1990-91), 10 *E. & T.J.* 272.

45 See A. Drache, "Your Taxes," *Financial Post*, Tuesday, 18 March 1996. However, it appears this position may soon change. Under a recent amendment to the *Charities Accounting Act*, it is expected that regulations will be adopted that will establish an administrative approval process to govern fiduciary compensation. See *Courts Improvement Act, 1996*, S.O. 1996, c. 25, s. 2(2).

46 See *French Protestant Hospital* and *Attorney-General*, [1951] 1 All E.R. 938 (C.H.D.).

47 See *David Feldman Charitable Foundation (Re)* (1987), 58 O.R. (2d) 626, 26 E.T.R. 86 (Surrogate Court); *Toronto Humane Society*, *supra*, note 42.

48 American Bar Association, *Revised Model Nonprofit Corporation Act* (Englewood Cliffs, N.J.: Prentice Hall, 1987). The 1952 *Model Nonprofit Corporation Act* was revised in 1957 and 1962.

49 *Not-For-Profit Corporation Law*, ss. 101-411

(McKinney, 1988).

50 *California Corporations Code*, ss. 5002-12000 (West Supp. 1988).

51 Home Office and HM Treasury, *Efficiency Scrutiny of the Supervision of Charities* (London: HM Stationery Office, 1987); U.K., H.C., *Charities: A Framework for the Future*, Com. 694 (1989); *Charity Law and Voluntary Organizations: Report of the Goodman Committee* (London: Bedford Square Press, 1976); *Charities Act, 1992*; *Charities Act, 1993*.

52 *Supra*, note 24.

53 See the *Religious Organizations Lands Act*, R.S.O. 1990, chap. R-23. Under this statute, limited special provision is made for religious organizations. "Religious organization" is defined under the statute as an association of persons that satisfies three requirements: 1) it must be charitable according to the law of Ontario; 2) it must be organized for the advancement of religion or for the conduct of religious worship, services or rites; and 3) it is permanently established as to continuity of its existence and as to its religious beliefs, rituals and practices. Under this statute, the trustees of the religious organization may hold land in perpetual succession without the necessity of incorporating. The value of this legal form for religions appears to be that they will not be restricted by the provisions of the *Corporations Act* and, therefore, there is no possibility of their own internal law conflicting with the provisions of the *Corporations Act*. The Act allows religious organizations to sublease land held by them for a maximum period of 40 years. Under the *Charities Accounting Act*, by contrast, no charity is permitted to own land that it is not actually using or occupying for its charitable purpose. For other forms of organization, see also s.16, *Perpetuities Act*, R.S.O. 1990, c. P-9, and *Re Denley's Trusts*, [1969] 1 ch. 373, [1968] 3 All E.R. 65 (Ch. D.).

54 At least, this is generally perceived to be the case. Hence the substantial preference for the corporate form of organization in Canada. However, it may well be possible to do everything under the trust form that one can do under the corporate form. Witness, for example, the success of the business trust in the American jurisdictions such as Massachusetts, which historically did not freely permit persons to form corporations.

55 In England and Wales the trust form is, for historical reasons, more important. But see J. Warburton, "Charity Corporations: The Framework for the Future?" [1990] *The Conveyancer* 95.

56 See *Income Tax Act*, S.C. 1950, c. 40, s. 21 and *Income Tax Act*, S.C. 1976. The distinction had been used for many years in the United States.

57 Called "charitable organizations."

58 Founders have the freedom to provide differently on any of these issues in the trust document. They generally do. The criticisms, therefore, apply to the default regime.

59 It is common for non-profit corporation statutes to provide permissibly that corporations may be incorporated for various kinds of nonprofit objects. For example, section 18 of the Ontario *Corporations Act*, *supra*, note 26, previously provided:

> A corporation may be incorporated to which part 5 applies where there is objects that are of a patriotic, religious, philanthropic, charitable, educational, agricultural, scientific, artistic, social, professional, fraternal, sporting or other athletic nature or that are of any other useful nature.

and s. 21 of the *Society Act*, *supra*, note 1 in British Columbia currently provides that:

> 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, supporting or other useful purposes.

60 See H. Hansman, "Reforming Nonprofit Corporation Law" (1981) 129 *U. Pa. L. Rev.* 497, and R. Atkinson, "Altruism in Nonprofit Organizations" (1990) 31 *Boston College L. Rev.*

61 See the *Charitable Gifts Act*, R.S.O. 1990, c. 26.

62 See generally D. Waters, *The Law of Trusts in*

Canada (Toronto: Carswell, 1984) ch. 14.

63 There are three doctrines of note, the Crown's prerogative to fashion a scheme, the courts scheme-making powers, and the cy-pres doctrine. See Waters, ibid.

64 The Office of the Public Trustee requires that the following provisions be included in the application for letters patent of incorporation:

> A. The corporation shall be carried on without the purpose of gain for its members and any profits or other accretions to the corporation shall be used in promoting its objects.
>
> B. The corporation shall be subject to the *Charities Accounting Act* and the *Charitable Gifts Act*.
>
> C. The directors shall serve as such without remuneration and no directors shall directly or indirectly receive any profit from his/her position as such provided that directors may be paid reasonable expenses incurred by them in the performance of their duties.
>
> D. The borrowing power of the corporation pursuant to any by-law passed confirmed in accordance with section 59 of the *Corporations Act* shall be limited to borrowing money for current operating expenses, provided that the borrowing power of the corporation shall not be so limited if it borrows on the security of real or personal property.
>
> E. Upon the dissolution of the corporation and after payment of all debts and liabilities, its remaining property shall be distributed or disposed of to charitable organizations which carry on their work solely in Ontario ... [or] solely in Canada.

See *Handbook*, *supra*, note 43 at 51-2.

65 See, for example, *The Business Names Act*, R.S.O. 1990, c. 17.

66 This is already required, in part, under s. 2 of the *Charities Accounting Act*, R.S.O. 1990, c. 27.

67 See the reports of the Manitoba and British Columbia Law Reform Commissions cited *supra*, note 35.

68 See Hawkins, "The Personal Liability of Charity Trustees" (1979) 95 *L.Q.R.* 99.

69 See, for example, P. Hogg, "Testamentary Dispositions to Unincorporated Associations" (1971) *Melbourne Univ. Law Rev.* 1; C.E.F. Rickett, "Purpose Gifts and Unincorporated Associations" (1981) *New Zealand Law Journal* 44; J. Warburton, *Unincorporated Associations: Law and Practice* (2d) (London: Sweet & Maxwell, 1992); and H.A. Ford, *Unincorporated Non-profit Associations* (Oxford: Clarendon Press, 1959).

70 See, generally, K.D. Lewis, "Casenote and Comment: Ramifications of Idaho's New Uniform Unincorporated Nonprofit Associations Act" (1994) 31 *Idaho L. Rev.* 297.

71 On the nature of the liability of a member of an unincorporated association for the torts of other members, see David J. Olivieri, "Annotation – Liability of Member of Unincorporated Association for Tortuous Acts of Association's Non-Member Agent or Employee," 62 *A.L.R.* 3d 1165 (1975).

72 *Kelner* v. *Baxter* (1866), L.R. 2 C.P. 174 (Common Pleas).

73 *Ashbury Railway Carriage & Iron Co*. v. *Riche* (1875), L.R. 7 H.L. 653.

74 A related doctrine declares *ultra vires* acts in excess of what is authorized by the corporation's statute.

75 *Bonanza Creek Gold Mining Co*. v. *R*., [1916] 1 A.C. (P.C.).

76 The provision was adopted in 1916 in Ontario.

77 B. Bromley, "Liabilities of Directors of Charitable Corporations" (unpublished) gives an example of the kind of problems that can arise:

> I was recently consulted by a charity which was incorporated under the *Societies Act* in British Columbia in the 1940s as a religious organization to carry on missionary work of a very specific nature. In the 1950s, a donor gave them property to start summer camps for children. Gradually, the camp ministry became the total focus of their activities

> even though it could not be considered an authorized activity, by even the most liberal interpretation of the society's purposes. Consequently, by the 1980s, they had a million dollar property and hundreds of thousands of dollars annual income devoted to an excellent charitable program which was totally *ultra vires*. I would not want to be a director of that organization in the event that there was a lawsuit against the Society on behalf of a child who may have become a quadriplegic as a result of a diving or skiing accident at the camp.

78 See, for example, Public Trustee for Ontario, "Submissions to the Ontario Law Reform Commission: Project on the Law of Charities" (1990-91) 10 *E. & T.J.* 272 at 277:

> We think that there ought to be a single regime applicable to the administration and management of charitable property (as distinct from organizational and other issues) rather than a multiplicity depending only upon how charities may organize themselves. We think also that the law of charitable trust ought to apply to the administration and management of charitable property regardless of the form in which a charity may be organized. The considerations that have led the courts to impose the obligations of trustees upon those holding property for charitable purposes are justice compelling if a charity is organized otherwise than as a trust.

In the *Toronto Humane Society* case, *supra*, note 18, Anderson J. held at 244 that charitable corporations are "amenable to the ancient supervisory equitable jurisdiction of the court." He also held that directors of charitable corporations cannot be paid for their services as director.

79 In *Re French Protestant Hospitals*, [1951] 1 All E.R. 938 at 940, the Court argued:

> It is said by counsel for the applicants that it is the corporation which is trustee of the property of the charity in question, and that the applicants, the Governor and Directors, are not trustees. Technically, that may be so. The property of the charity is, of course, vested in and held by the corporation. The corporation however exists only according to the rules of law and it is not an actual person capable of acting on its own motion and in any way whatever. It seems to me that in a case of this kind, a court is bound to look at the real situation which exists. It is obvious that the corporation is completely controlled by the governor, deputy governor and directors, and it is, therefore, those persons who in fact control the corporation and decide what shall be done. Those persons are as much in a fiduciary position as trustees in regard to any acts which are done in regard to the corporation and its property. It will be entirely illegal if they were simply to put the property or the proceeds of the property of the corporation in their pockets and make use of if for their own individual purposes or for their purposes of the whole and not for the purposes of the charitable trusts for which the property is held. Therefore, it seems to me plain that they are to all intents and purposes and for the purposes of this case bound by the rules which affect trustees.

The issue whether directors of charitable corporations are or are not trustees has been discussed in: William I. Innes, "Liability of Directors and Officers of Charitable and Non-Profit Corporations" (1993) 13 *E. & T.Q.* 1; Maurice C. Cullity, "Case Comment: In the Matter of the Application of The Canadian Foundation for Youth Action" (1977), 2(1) *The Philanthropist* 41; Maurice C. Cullity, "Case Comment: In the Matter of The Toronto Humane Society, the David Feldman Charitable Foundation" (1989), 4 *The Philanthropist* 12; David R. Foster and Lara C. Johnson, "Responsibilities and Duties of Directors of Nonprofit Corporations – Liability of the Nonprofit Director," American Bar Association, Section of Business Law, Annual Meeting, San Francisco, California, August 8-10, 1992; J.D. Gibson, "Liability of Directors of Ontario Charitable Corporations" (1979-81), 5 *E. & T.Q.* 71; John M. Hodgson and Anne C. McNeely, "Directors and Trustees: The Charitable Corporation and Trusteeship," *The Charitable Mosaic* (The Canadian Bar Association-Ontario, Department of Continuing Legal Education, Looseleaf, Seminar, September 27, 1983); John M. Hodgson and David Allen, "Liability of Directors of Non-Share Capital Corporations," Continuing Legal Education, *Non-Share Capital Corporations* (Toronto: Canadian Bar Association-Ontario, 1986).

80 The difficulty in sorting out the precise nature of the duties owed by directors of a nonprofit corporation is not peculiar to Canada. See, Jane C. Schlicht, "Piercing the Noncorporate Veil" (1982) 66 *Marquette L. Rev.* 134; Note, "The Fiduciary Duties of Loyalty and Care Associated with the Directors and Trustees of Charitable Organizations" (1978) 64 *Virginia L. Rev.* 449.

See also *Scott on Trusts*, 4th ed., W.F. Fratcher, Editor (Boston: Little Brown & Co. 1989), vol. 4A, para. 348.1, p. 23-25:

> The truth is that it cannot be stated dogmatically that a charitable corporation either is or is not a trustee. The question is in each case whether a rule that is applicable to trustees is applicable to charitable corporations, with respect to unrestricted or restricted property. Ordinarily the rules that are applicable to charitable trusts are applicable to charitable corporations, as we have seen, although some are not. It is probably more misleading to say that a charitable corporation is not a trustee than to say that it is, but the statement that it is a trustee must be taken with some qualifications. Thus where property is left by will to a charitable corporation, whether it may be used for the general purposes of the corporation or whether the devise of request is subject to restrictions as to its use, and the property is conveyed by the executor to the corporation, the corporation is not thereafter bound to account as if it were a testamentary trustee. The situation is quite different from that which arises where property is left by will to individual trustee, or to a trust company, charged with a duty to make the property productive and to pay the income to a charitable corporation.

81 One interesting explanation for the confusion of trust law with corporate law in the charitable domain is provided by L.S. Sealy, "The Director as Trustee," [1967] *Cambridge L.J*. 83 at p. 85-86:

> It is submitted that there is no hidden mystery nor missing link lying undiscovered in the pre-history of company law behind the trustee appellation: the real mystery is why the old label has survived in modern usage. In the limited legal vocabulary of the day, there is no other word which judges would wish to use. It was sufficient for them to reason that the directors had accepted an appointment or "trust"; therefore, they were "trustees" and accountable for "breaches of trust." The "trustee" in the strict sense in whom property is legally vested for the benefit of others was not legally identified until well into the 19th century, when the expression "fiduciary" was eventually accepted to differentiate true trusts from other relationships, like that between a director or a promoter in his company which .... in some degree resemble them.

82 One common situation of theft in the commercial context is directors taking opportunities that belong to the corporation. The leading Canadian case is *Canadian Aero Service Ltd*. v. *O'Malley*, [1974] S.C.R. 592. The law prohibits the taking by a fiduciary of an opportunity that belongs to the corporation. The law defines reasonably widely the circumstances under which the opportunity belongs to the corporation. For example, it does not matter that the corporation itself was not in a position to exploit the opportunity because of its own insolvency or impecuniosity.

83 C. Baxter, "Trustees' Personal Liability and the Role of Liability Insurance" [1996] *The Conveyancer* 12, cites the example of Rosemary Aberdouur who "was allowed to relieve the National Hospital for Neurology and Neurosurgery of 2.4 million pounds" (Citing Ch. Comm. Rep. [1992] p. 24).

84 The *parens patriae* jurisdiction of the provincial Crown in respect of charity gives it the power to regulate the content and the satisfaction of the fiduciary duties of charitable fiduciaries of out-of-province corporations. The Office of the Public Trustee has in fact stated this. The extent of this constitutional authority of provincial Crowns has not been tested, although there is caselaw on the closely related issue of the power of one province to regulate the business or the internal affairs of a corporation incorporated in another province or federally incorporated. New York and California have statutory provisions regulating corporate law matters of out-of-state corporations.

85 [1925] 1 Ch. 407.

86 See, generally, Ziegel et al., *supra*, note 27, ch. 6.

87 283 F. Supp. 643 (Dist. Ct. 1968).

88 J. Gibson, "Liability of Directors of Ontario Charitable Corporations" (1979-81) 5 *E. & T.Q.* 71 at 76.

89 On the business judgment rule, see *Aronson* v. *Lewis*, 473 A.2d 805 (Del. 1984) [hereinafter *Aronson*]. See R.C. Clark, *Corporate Law* (Boston: Little Brown, 1986); and D. Block, N. Barton and S. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors and Officers* (Clifton, NJ: Prentice Hall, 1987).

90 From *Aronson* v. *Lewis*, ibid.

91 The House of Lords adopted a single objective standard applicable to all trustees. See *Leroyd* v. *Whiteley* (1887), 12 App. Cas. 727 (H.L.); *Knox* v. *MaKinnon* (1888), 13 App. Cas. 753 (H.L.); and *Rae* v. *Meek* (1889), 14 App. Cas. 558 (H.L.). These cases were adopted in Canada and have been applied by the Supreme Court of Canada as the sole standard applicable to trustees. See *Davies* v. *Nelson*,

[1928] 1 D.L.R. 254, 61 O.L.R. 457 (C.A.); *Fales* v. *Canada Permanent Trust Co.* [1977] 2 S.C.R. 302, [1976] 6 W.W.R. 10.

92 S. 35, *Trustee Act*, R.S.O. 1990, c. 28. Similar provisions have been adopted in every Canadian jurisdiction, except Prince Edward Island. The provision originated in 1896, *The Judicial Trustees Act, 1896* (U.K.), c. 35, s. 3(1).

93 Courts have taken into consideration the fact that the trustee is a paid professional in establishing a higher level of duty. See, for example, *Fales*, *supra*; *National Trustees Co. of Australasia Ltd*. v. *General Finance Co. of Australasia Ltd*., [1905] A.C. 373 (J.C.P.C.); *Re Windsor Steam Coal Co. (1901), Ltd*., [1929] 1 Ch. 151 (C.A.); *Krendel* v. *Frontwell Investments Ltd*. (1966), 64 D.L.R. (2d) 471. American law recognizes a different standard for professional trustees. See *Scott on Trusts*, *supra*, note 54; Gilman, "Trustee Selection; Corporate versus Individual" (1989) *Tr. & Est*. 29; Note, "Standard of Care for Corporate and Professional Trustees" (1956) 42 *Virginia Law Rev*. 665; Note, "Standard of Care for Corporate Trustees" (1948-49) 16 *Chicago Law Rev.* 579. See also American Law Institute, *Restatement of the Law of Trusts* (1935) section 174 and American Law Institute, *Restatement of the Law of Trusts*, 2d ed. (1959) section 174.

94 See, Ontario Law Reform Commission, *Report on the* "The Trustees Standard of Care" (1985-86) 7 *E. & T.Q*. 334 and R. Paling, "The Trustee's Duty of Skill and Care" (1973) 37 *The Conveyancer and Property Lawyer* (N.S.) 48.

95 This standard has also been recommended by the Conference of Uniform Commissioners on the Uniformity of Legislation in Canada, and by the Uniform Probate Code (U.L.A.), s. 7-302

96 *Aberdeen Railway Co.* v. *Blaikie Bros.* [1843-60] All E.R. Rep. 249, 2 Eq. Rep.1281 (H.L.).

97 The indemnification provision of the Ontario *Corporations Act*, which is typical of indemnification provisions in Canadian nonprofit corporation statutes, is set out in section 81 of that Act:

> Every director of the company and his heirs, executors and administrators and estate and effects respectively may, with the consent of the company, given at any meeting of the shareholders from time to time and at all times be indemnified and saved harmless out of the funds of the company from and against a) all costs, charges and expenses whatsoever that he sustains or incurs in or about any action, suit or proceeding that is brought, commenced or prosecuted against him for or in respect of any act, deed, matter or thing whatsoever made, done or permitted by him in or about the execution of the duties of his office; and b) all other costs, charges and expenses that he sustains or incurs in or about or in relation to the affairs thereof, except such costs, charges or expenses as are occasioned by his own wilful neglect or default.

On directors and officers liability insurance, see Colin Baxter, "Demystifying D & O Insurance" (1995) 15 *O.J.L.S.* 537; Finch, "Personal Accountability and Corporate Control: The Role of Directors and Officers Liability Insurance" (1994) 57 MLR 880; and Colin Baxter, "Trustees Personal Liability and the Role of Liability Insurance" [1996] 60 *Conveyancer* 12. A common complaint is that these types of provisions do not authorize indemnification of sufficient scope.

98 These provisions are not always very well drafted. Under s. 70 and 71 of the Ontario *Corporations Act*, it is not clear whether the interested director should count as part of the quorum. Sometimes the scope of the interest is not sufficiently well defined either.

99 S. 126(2).

100 S. 80 of the Ontario statute, for example. Statutory indemnification provisions often do not address the full range of issues of concern to directors. For example, statutory indemnification provisions often do not provide for an indemnification where the director is sued derivatively for a breach of his obligation of care to the corporation and where the director settles a claim of a third party. Indemnification provisions often provide that no indemnification can be provided without further court approval. Further, indemnification assumes that the corporation is solvent and indemnification, in fact, often depends on the continued good relations between the director seeking indemnification and the other directors on the board.

101 In *Toronto Humane Society*, *supra*, note 42, the court held that any remuneration to be paid to charitable directors required the prior approval of the court or a right to such remuneration must be stated in the

documents establishing the corporation. In *Re the French Protestant Hospital*, *supra*, note 42, the court held that directors could not be paid for professional services rendered to the corporation. In *Harold G. Fox Education Fund*, *supra*, note 42, however, the court dealt with an application by a director to the court for remuneration for services rendered other than as a director of the charitable corporation. The letters patent of the corporation provided that:

> ... the directors shall serve without remuneration, and no director shall directly or indirectly receive any profits from his position as such; reasonable expenses incurred by any director in the performance of his duties may be paid.

Madam Justice VanCamp relied on the provisions of section 126 of the Ontario *Corporations Act*. Section 126 provides that the letters patent of a charitable corporation may provide for reasonable remuneration for directors in compensation for services provided to the corporation other than the services of a director. She held that the letters patent of incorporation prohibited only payment for services as director and, therefore, held that payment to the directors otherwise was authorized. The court held as well that the provision for payment may be authorized in advance.

102 This matter is also regulated under the *Income Tax Act*. For a charity to maintain its charitable status, no part of its income may inure to the benefit of any proprietor, member, shareholder trustee or settlor. No mention in the Act is made of capital payments to these people. Capital transfers in the case of nonchar-itable nonprofits is permitted. See IT 409. Capital transfers are not permitted on a winding up of charities. See s. 188(1) and (2).) The Minister, however, does not object to reasonable salaries and benefits. For nonprofits, see IT 496 and for charities, see Info Circular 80-10R.

103 The situation in England and Wales in respect of these two matters has recently changed. In 1994, the Charity Commissioners stated their approval of the principal that charities be permitted to purchase liability insurance for their trustees. This makes great sense.

104 There are many other types of controls. The *Income Tax Act* prohibits public and private foundations from acquiring control (50 percent) of a corporation. The *Charitable Gifts Act*, R.S.O. 1990, c. C-8 requires that the proceeds from the sale of a charity's stake in a business must be invested in *Insurance Act Investments*.

105 See, s. 32(2) of the *Society Act*, *supra*, note 1. Interestingly, it appears that federal and extra-provincial corporations may not provide these types of insurance benefits, since doing so requires the consent of the Superintendent of Financial Institutions and s. 4(3) provides that the directors of the applicants for consent must be residents of the province. Under s. 2(3), investments are restricted to trustee investments unless the constitution or by-laws provide otherwise. See further, R.J. Burke-Robertson and A. Drache, *Non-Share Capital Corporations* (Toronto: Carswells, 1995).

106 The *Income Tax Act* restricts borrowing by foundations to operating expenses.

107 See Decisions of the Charity Commissioners (1994), vol. 2, p. 28.

108 The Uniform Law Conference has dealt with this issue on a number of occasions and is currently in the process of preparing another report. For a discussion of the Canadian developments in this area, see Waters, *supra*, note 36, p. 765-787.

109 The *Charities Accounting Act* in Ontario establishes a modest supervisory regime applicable to a group of charitable purpose organizations. The precise scope of the statute's application is not clear, however. In addition to charitable purpose trusts and corporations, it also applies to trusts and corporations established for religious, educational and other public purposes. It is not clear from the wording of the statute whether it is meant to apply to unincorporated associations established for these purposes, but it probably does not. We look at this law in greater detail in chapter three.

Broad powers are given to Canadian courts to enforce the duties imposed on directors under the environmental and employment standards statutes as well. See *Canadian Environmental Protection Act*, R.S.C. 1985, c. 16, s. 122 and Ontario *Environmental Protection Act*, R.S.O. 1990, s. 194. See also *R. v. Bata Industries Ltd.* (1991), 70 C.C.C. (3d) 391 (Ont. Prov. Ct). With respect to employment standards legislation, see, for example, *Employment*

Standards Act, R.S.O. 1990. The extent of the liability in Canada varies from a low of two months in British Columbia to a high of six months in Ontario. In Ontario, the liability was extended recently to management and other fiduciaries. In British Columbia, interestingly, it does not apply to a director or officer who does not receive any remuneration for the services performed.

110 Standing to sue, for example, could be awarded on a discretionary basis by courts pursuant to statutory authority. The statute might require the court to take into account a number of elements: 1) the gravity of the complaint and the nature of the remedy sought; 2) the fraudulent nature of the misconduct; 3) the availability of a public agency; and 4) the nature of the relationship between the person complaining and the charity. See further, M.G. Blasko et al., "Standing to Sue in the Charitable Sector" (1993) 28 *U.S.F.L.R.*. 37.

Another way to balance the need to protect the nonprofit corporation from vexatious suits with the need to expand the scope of persons who are permitted to hold the directors accountable for breaches of fiduciary duty is to restrict access to the derivative action. The Tennessee *Nonprofit Corporation Act*, for example, permits only directors and 50 or more members to sue derivatively. See, *Tennessee Code, Annotated*, section 48-51-101 (1988).

111 On the common law position of directors, see *Re Dominion Trust Co.* 23 C.B.R. 401 (1917).

112 See the report of the Toronto Stock Exchange Committee on Corporate Governance in Canada, "Where Were the Directors" (December 1994).

113 The *Nathan Report* (U.K., 1952), the *Goodman Report*, *supra*, note 27, and *The Whitepaper*, *supra*, note 27, all discussed the cy-pres doctrine in detail. The *Whitepaper* concluded against recommending a statutory modification of the doctrine on the basis that the problem was not the doctrine but the court's narrow view of their discretion in applying it. The OLRC in its 1984 *Report on Law Trust* did recommend a modest change to the formulation of the doctrine with a view to encouraging courts to take a more generous view of their role. As a result of the *Nathan Report*, the power to modify charitable objects cy-pres is exercised by the Charities Commissioners in the United Kingdom.

114 See J.G. Simon (1987) 21 *U.S.F.L.R.*. 641.

115 R. Atkinson, "Reforming Cy-Pres Reform" (1993) *Hastings L.J.* 1112.

116 The current practice in Ontario is for the Public Trustee to vet applications to amend the letters patent.

117 Common law establishes the right of the Attorney General to act on behalf of the Sovereign who, as parens patriae, is the guardian of the charity.

118 In 1992, there was widespread media coverage of the United Way of America (UWA) scandal, involving the payment of almost $500,000 in salary and benefits to the organizations' chief executive officer, William Aramony, and the transfer of funds to spinoff organizations in which Aramony, his family and top UWA officials had financial interests. In a U.S. Gallup poll conducted in the following year, 54 percent of the respondents indicated that they thought charities were less trustworthy than 10 years ago. Almost three-quarters were of the view that more regulation of charities was necessary.

119 Royal Commission on Taxation, *Report, Volume 4 – Taxation of Income*, (Ottawa: Queen's Printer, 1966).

120 Based on discussions with officials in the Charities Division, Revenue Canada.

121 Based on discussions with officials in the Charities Division, Revenue Canada.

122 Nonprofit organizations, along with agricultural organizations, boards of trade and chambers of commerce, that meet the established criteria must file the "Non-Profit Organization Information Return." The last condition means that once an organization has filed, it must thereafter submit returns to Revenue Canada.

123 Revenue Canada, "A Better Tax Administration in Support of Charities," November 1990, p. 8.

124 Ibid, p. 9.

125 Implicit in this statement is the notion that government is itself a patron of charities by virtue of the tax subsidies it provides to these organizations.

126 This is a partial list of the "items of non-compliance" found in the survey. The information was provided by officials in the Charities Division, Revenue Canada.

127 This issue is revisited in Section 3.4.2 where the desirability of fundraising regulations is discussed.

128 This is discussed in a companion CPRN paper by Kathleen M. Day and Rose Anne Devlin, *The Canadian Nonprofit Sector*, Working Paper No. CPRN|02, 1997.

129 Similar criticisms have been made in the United States with respect to the public information that is available through the filing of Form 990. Baruch College, City University of New York, *Enhancing the Quality of Public Reporting by Nonprofit Organizations* (New York: City University of New York, 1991).

130 In a study for the Canadian Centre for Philanthropy, David Sharpe discovered some numbers reported in Revenue Canada's T1030 form did not add up, and other numbers had been mistakenly reported in thousands of dollars rather than dollars. David Sharpe, *A Portrait of Canada's Charities* (Toronto: Canadian Centre for Philanthropy, 1994). Reporting problems are discussed in Day and Devlin, ibid.

131 The revocation tax is due within one year after the effective date of revocation and equal to the value of the assets the charity has not distributed to qualified recipients.

132 This is based on the response of the Department of Finance to comments in the Auditor General's 1990 Report, p. 264.

133 The Charity Commissioners for England and Wales, for example, employ almost eight times the staff of Revenue Canada's Charities Division to oversee a sector that comprises somewhat over twice the number of organizations in Canada.

134 Section 3 requires that holdings in excess of the prescribed limit, "given or vested pursuant to a will or other testamentary instrument," be disposed of "within seven years after the death of the testator." This period may be extended from time to time, however, by a judge of the Ontario Court.

135 The position of the Ontario Public Trustee with respect to lending and borrowing by fiduciaries was discussed more fully in Chapter 2.

136 *Not-For-Profit Incorporator's Handbook*, Office of the Public Trustee and Ontario Ministry of Consumer and Commercial Relations.

137 The *Courts Improvement Act* S.O. 1996, c. 25, s. 2(2), which amends s. 5(1) and adds s. 5.1 to the *Charities Accounting Act* R.S.O. 1990, c. C-10 allows the Attorney General to make regulations on the advice of the Public Guardian and Trustee. Bill 61, given First Reading June 5, 1996, which amends ss. 1(1), 1(5), 5(3) and adds s. 13(1) to the *Charities Acounting Act* R.S.O. 1990, c. C-10 allows parties to proceed with certain actions without seeking court approval.

138 The staff may be supplemented by an articling student. Salaries account for about 98 percent of the unit's total costs. Net revenue requirements are lower than this because the Office received almost $250,000 in court-authorized fees over the 1995-96 fiscal year.

139 This is based on discussions with officials in the Charity Property Unit.

140 The Public Trustee may, but need not, inquire into complaints of abuse, neglect or exploitation of charitable property. The Trustee may not follow up on a complaint if: another person or office has legal standing or primary responsibility; the matter involves a small amount or lacks significance; the complaint appears intended to harass, put pressure on, or embarrass an individual or organization; the

complaint is not made in accordance with required procedures; sufficient supporting evidence is not provided; or the resources of the Office are already fully committed.

141 For example, it must be stated that the corporation: is not being carried on for the gain of its members; is subject to the CAA and the CGA; and, is not to provide remuneration to its directors. These and other special provisions are outlined in Appendix J of the *Not-For-Profit Incorporator's Handbook*.

142 Referred to in Speech by Eric Moore, Director, Charities Division Office, to the 1995 National

Conference of the Canadian Council of Christian Charities, Mississauga, Ontario, September 28, 1995.

143 This is illustrated by the recent case in which the Public Trustee challenged the actions of private trustees administering the estate of Harold Ballard, the majority owner of Maple Leaf Gardens in Toronto. Steve Stavro, one of the administrators of the estate, and his partners in MLG Ventures bought control of the Gardens from the estate in 1994 at a price of $34 a share. After using the proceeds to pay off assorted debts, the private trustees indicated there would be very little left in the estate to fund the Harold E. Ballard Foundation. The Public Trustee launched a lawsuit, alleging that the charities that were beneficiaries of the estate had been harmed by the failure to sell the Gardens' shares in an open auction where they would have brought a much higher price. The suit was dropped in April 1996 when Stavro and Ventures agreed to pay an additional $23.5 million plus interest to the Ballard Foundation over the next four years.

144 Speech by Susan Himel, Ontario Public Trustee, to the Canadian Association of Gift Planners Conference, April 21, 1995.

145 Paul Reynolds, "Administration of the Charities Accounting Act," in *Legal and Tax Issues Affecting the Charitable Sector* (Toronto: The Canadian Centre for Philanthropy, 1984).

146 On the reputation of Ontario, see, for example, the "General Comments" of C. Arthur Bond, in *Law, Tax and Charities* (Toronto: The Canadian Centre for Philanthropy, 1990).

147 While the *Not-For-Profit Incorporator's Handbook* says that "financial statements should be audited," it indicates that unaudited financial statements can be sent in with a "justifying explanation" signed by all of the trustees or directors.

148 Based on a Speech by Eric Moore, September 1985, op. cit.

149 For a recent discussion of the role of mandatory disclosure in securities markets, see Paul G. Mahoney, "Mandatory Disclosure as a Solution to Agency Problems," *The University of Chicago Law Review* 62, 1995.

150 A 1982 study reported that "at least half of its [the Commission's] day-to-day work (and possibly rather more) continues the older tradition of supervising permanent endowments." Francis Gladstone, *Charity, Law and Social Justice* (London: Bedford Square press/NCVO, 1982).

151 National Audit Office, *Monitoring and Control of Charities in England and Wales* (London: HMSO, 1987).

152 In 1988, the Public Accounts Committee of Parliament produced a report entitled, "Monitoring and Control of Charities." A report by Sir Philip Woodfield and his team entitled "Efficiency Scrutiny of the Supervision of Charities" was published in 1987. These reports confirmed the problems identified by the NAO.

153 *Charities: A Framework for the Future*, presented to Parliament by the Secretary of State for the Home Department, May 1989 (London: HMSO, 1989).

154 Most of the *Charities Act 1992*, together with most of the 1960 and 1985 Acts, have been consolidated in the *Charities Act 1993*. With the exception of certain provisions, the 1993 law came into force on August 1, 1993.

155 The first schedule to the *Charities Act 1993* provides for a Chief Charity Commissioner and two other commissioners. Of these three, at least two must be barristers or solicitors. In addition the Home Secretary can, with Treasury approval, appoint up to two additional commissioners who need not be legally qualified.

156 *Charities Act 1993*, Sections 1(3) and 1(4).

157 Before an inquiry is opened, a preliminary evaluation is carried out to see whether there is a prima facie cause for concern. In 1994, only 25 percent of the preliminary evaluations led to inquiries.

158 As well, land may become vested in the Official Custodian by an order of the court.

159 To receive tax concessions, an organization must also satisfy a second test, which requires it to establish that the income on which relief is sought has been applied to charitable purposes. This is discussed in Gladstone, op. cit.

160 Based on *Report of the Charity Commissioners for England and Wales* (London: HMSO), various years.

161 Recent publications include: *The Carrying Out of an Independent Examination: Directions and Guidance Notes*; *Accounting for the Smaller Charity*; *Accruals Accounting for the Smaller Charity*; and *The Charities Statement of Recommended Practice: Accounting by Charities*.

162 A scheme may be for the application of property cypres. Alternatively, as Philip Petit states: "It may directed where the exact ambit of the charitable purpose is not clear, where the trustees are dead, or disclaim or refuse to act, or have misapplied the trust property, where the income of the charity has substantially increased, and in other cases where it is an appropriate remedy." P. Petit, *Equity and the Law of Trusts*, (London: Butterworths, 1993).

163 It must be shown that the the mode of application chosen by the donor has "ceased in any other way to provide a suitable and effective method of using the property available by virtue of the gift, regard being had to the spirit of gift." [*Charities Act 1993*, Section 13(1)(e)(iii)]. The *Charities Act* also allows an alteration of the original purposes of a charity in a number of other circumstances, including: "where the original purposes ... have, since they were laid down, been adequately provided for by other means" [Section 13(1)(e)(i)]; "where the property available by virtue of the gift and other property applicable for similar purposes can be more effectively used in conjunction, and to that end can suitably, regard being had to the spirit of the gift, be made applicable to common purposes" [Section 13(1)(c)]; and, where the original purpose has ceased to be charitable.

164 The requirements established by the Commission are in addition to those which apply to incorporated charities under the Companies Acts.

165 Charities, with income over £100,000 but under £250,000 must prepare their accounts on an accrual basis, but may choose an independent examination rather than an audit. Only organizations with income or expenditure over £250,000 in the current or either of the two previous years, must have their accounts professionally audited.

166 *Annual Report of the Charity Commissioners 1992*, p. 1.

167 This is part of the definition of the Rule of Law given in Wade's *Administrative Law*.

168 Similar concerns have been raised recently in Canada about the discretionary powers of the Ontario Securities Commission, a body with supervisory responsibilities somewhat akin to those of the Charity Commission. For example, Jeffrey G. MacIntosh, "Securities Regulation and the Public Interest: of Politics, Procedures and Policy Statements – Part 1," *Canadian Business Law Journal* 24(44), 1994-95, and "Part 2," *Canadian Business Law Journal* 24(45), 1994-95.

169 At the federal level, all regulatory proposals must be accompanied by a Regulatory Impact Analysis Statement.

170 Canadian Centre for Philanthropy and Canada West Foundation, *Charitable Fundraising in Canada* (Toronto: Canadian Centre for Philanthropy, 1996).

171 It was found that, in 1992, three-quarters of all the funds raised in Alberta went to nonprofits that incurred fundraising costs that were less than 30 percent of proceeds. In the case of nonprofits using outside fundraisers, however, most (i.e., almost 80 percent) incurred fundraising costs that exceeded 50 percent of proceeds. Nancy Palmer, *Fundraising for Charities*, Canada West Foundation and Canadian Centre for Philanthropy, March 1995 (draft).

172 In the United States, for example, the *Philadelphia Inquirer* ran an extended series, beginning on April 18, 1993, focusing on the misconduct of exempt charities. Critical articles have also appeared in the *Los Angeles Times* (November 20, 1992), *Newsweek* (March 16, 1992), the *Washington Post* (March 1993 and February 10, 1994), the *Wall Street Journal* (May 13, 1993), *Time* (August 1993), and *Kiplinger's* (December 1993). In Canada, a recent example is the December 30, 1995 article in the *Toronto Star*, "Fundraising Firm Pockets Cash."

173 Concerns about fundraising costs and the amounts paid to private fundraising consultants are among the issues highlighted in the Revenue Canada Discus-

sion Paper, "A Better Tax Administration in Support of Charities," op. cit. Similar concerns have been raised in the United States and in Annual Reports of the British Charity Commissioners.

174 As is discussed in a later section, we believe it is important to encourage efforts by the nonprofit sector to regulate itself. This statement simply records the fact that effective programs of self-regulation are notoriously difficult to achieve in sectors with a large number of diverse participants. As long as there are significant potential benefits from noncompliance, association members will have an incentive to ignore the regulations and free-ride on the compliance of others.

175 These are discussed in E. Harris, L.S. Holley and C.J. McCaffrey, "Fundraising into the 1990s: State Regulation of Charitable Solicitation After *Riley*," *University of San Francisco Law Review* 24(4), Summer 1990.

176 444 U.S. 620 (1980).

177 Ibid. at 635.

178 467 U.S. 947 (1984).

179 Ibid. at 964, note 12.

180 Under the North Carolina act, fees were divided into three categories: 1) fees under 20 percent of collections were deemed to be reasonable; 2) fees between 20 and 30 percent were presumptively excessive, pending proof that they were justified by the costs of disseminating information or related activities; and 3), fees of 35 percent or more were "excessive and unreasonable" unless they could be proved necessary to the campaign.

181 108 S. Ct. 2667 (1968).

182 *Epilepsy Canada* v. *Alberta (Attorney General)*, [1994] 20 Alta. L.R. (3d) 44.

183 Ibid. at 53.

184 Medicine Hat's bylaws restricted the number of door-to-door campaigns that could be conducted in a single area of the city to four per month; limited the number of campaigns that any charity could conduct in the city in a single year to three; and required that at least 42.5 percent of the funds raised in a campaign flow through to a charitable purpose. Discussed in testimony of Rainer Knopf at initial trial, June 9, 1993.

185 This is discussed in R. Steinberg, "Economic Perspectives on Regulation of Charitable Solicitation," *Case Western Law Review* 39, 1988-89.

186 In the United Kingdom, for example, individuals are disqualified from being a trustee or director of a charity if they have been convicted of certain offences or removed from their trustee's or director's position by order of the Commissioners or High Court.

187 This is used as an argument for point-of-solicitation disclosure by Espinoza, who is critical of the Supreme Court's decision in *Riley*. Leslie G. Espinoza, "Straining the Quality of Mercy: Abandoning the Quest for Informed Charitable Giving," *Southern California Law Review* 64, 1991.

188 The Act is administered by the Housing and Consumer Affairs Division of the Municipal Affairs Department of the Alberta Government. A staff of 30 officials is responsible for administering all Consumer Affairs standards. The time that will be devoted to the ongoing administration of the CFA has been estimated (by officials within the Division) at the equivalent of approximately two person-years.

189 For example, one letter sent out by a U.S. cancer research foundation included a recipe for bran muffins. This "educational message" allowed the organization to allocate mailing costs to program expenditure and keep recorded fundraising costs below 25 percent of total revenue. In another case, program expenditures were artificially inflated by paper transactions involving relatively worthless commodities. The primary intent was again to reduce the fundraising ratio. These examples are contained in Rainer Knopff, op. cit.

190 Part 5, Section 44, of the Act.

191 It is significant, however, that the Minister is empowered (under Sections 35 and 36 of the CFA) to inspect the premises of a charity or a professional fundraiser to ensure compliance with the Act and the accompanying regulations.

192 Following the proposals in Chapter 2, stakeholders would also have the right to take action against managers and directors that breached their fiduciary obligations by allowing the organization to deviate from its stated objectives.

193 It could be prudent to delay the delegation of such powers until an adequate base of regulations has been established and the supervisory commission has gained the confidence of the sector.

194 While the Agreement on Internal Trade is generally recognized as an important initial step towards the elimination of barriers to the free movement of goods, services, persons and investments in Canada, it has notable weaknesses, particularly as compared to international trade agreements. This is discussed in Margaret Biggs, *Building Blocks for Canada's New Social Union*, Working Paper No. F|02 (Ottawa: Canadian Policy Research Networks, 1996).

195 Administrative and equivalency agreements have been established under the *Canadian Environmental Protection Act*, and administrative agreements have been worked out under the *Fisheries Act*. The federal government has recently signed such agreements with Alberta, British Columbia, Quebec, Saskatchewan, and the Atlantic provinces.

196 The result, as one observer has noted, is that ethical codes operate according to Gresham's Law: "If a sanction cannot be imposed for the violation of ethical codes, then the honorable will follow the codes and the dishonorable will not. If any advantage accrues to the dishonorable for code violations, then the bad organizations will crowd out the good." (Harvey Dale, Director of New York University's Program on Philanthropy and the Law speaking to the National Center for Nonprofit Boards' first National Leadership Forum, 1993.)

197 This is discussed in *Regulations and Competitiveness*, Seventeenth Report of the Standing Committee on Finance, January 1993.

198 This issue is addressed in a different context in Ronald Hirshhorn, *Product Safety Regulation and the Hazardous Products Act*, Economic Council of Canada Technical Report No. 10, June 1981.

199 An example is the Better Business Bureau of Metropolitan Toronto, which, through its Charities Review Board, provides a rating sevice of charitable organizations operating in the Toronto area. In the United States, there are a number of independent "watchdog" organizations. At the national level, these include the National Charities Information Bureau, the Philanthropic Advisory Service (a division of the Council of Better Business Bureaus), and the American Institute of Philanthropy. Up to now, these organizations have focused mainly on financial reporting and avoided the more difficult issue of performance measurement.

200 Treasury Board of Canada, *Responsive Regulation in Canada*, The Government Reply to the Subcommittee on Regulations and Competitiveness, April 1993, p. 27.

201 In Canada, a standards organization must be accredited by the Standards Council of Canada to perform ISO 9000 registrations.

Advisory Committee Members
CPRN Nonprofit Sector Project

Judith Maxwell (Chair)
President
CPRN
Ottawa, Ontario

Ron Hirshhorn
Project Director
CPRN
Ottawa, Ontario

Dian Cohen
President
DC Productions Limited
Ayer's Cliff, Quebec

Arthur Drache, QC
Solicitor
Drache, Burke-Robertson, Buchmayer
Ottawa, Ontario

David Elton
President
Canada West Foundation
Calgary, Alberta

Michael Hall
Research Director
Canadian Centre for Philanthropy
Toronto, Ontario

Shira Herzog
Vice-President
The Kahanoff Foundation
Toronto, Ontario

Jack Mintz
Professor
Faculty of Management
University of Toronto
Toronto, Ontario

Paul Reed
Senior Social Scientist
Statistics Canada
Ottawa, Ontario

Michael Trebilcock
Professor
Faculty of Law
University of Toronto
Toronto, Ontario

Christa Wessel
Partner
McCarthy Tétrault
Toronto, Ontario

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