

# LEGAL LIABILITY AND RISK MANAGEMENT: A HANDBOOK FOR DIRECTORS

Rachel Corbett<sup>1</sup>  
Centre for Sport and Law  
Brock University

May 2002

## 1. Introduction

According to the 2000 National Survey of Giving, Volunteering and Participating, over 40 percent of Canadian volunteers hold positions on boards and committees. Although those who fill these leadership positions are essential to the effective governance of voluntary organizations, many board members are unaware of the legal ramifications of their volunteer work. At the same time, however, our society is more litigation-oriented and the public is expecting non-profit organizations to be more accountable and business-like in managing their affairs. Volunteer board members are right to be concerned about their personal liability.

This handbook informs board members about their legal responsibilities and provides practical suggestions for managing these risks and minimizing personal liability. While this handbook contains legal information, it does not provide legal advice. Neither its authors nor Volunteer Canada are in a position to determine whether organizations or individuals have fulfilled their legal duties or satisfied the applicable standard of care in every circumstance. Individuals and organizations seeking specific advice should consult with a lawyer.

This handbook is not intended to scare people away from volunteering as a board member with their favourite voluntary organization or charity. Risk and responsibility are facts of life and every activity we undertake will always involve a certain amount of risk. The volunteer director needs to understand these risks so that he or she can act reasonably and appropriately. The purpose of this handbook is to raise awareness of the legal risks facing directors, and offer directors and the organizations with which they are affiliated, some practical suggestions for minimizing these risks.

---

<sup>1</sup> This document was prepared for Volunteer Canada, and may be used with their permission and permission of the author.

## 2. Who is a director?

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

Organizations come in a variety of types and sizes, under a variety of names. A non-profit organization can be referred to as a club, association, society, corporation, league, or committee (as in the Canadian Olympic Committee) – in this handbook, the generic term “organization” is used. As well, some organizations are small with no staff and no office, some have a few staff and some are large entities with many staff and volunteers.

Likewise, some organizations are governed by administrative or “hands-on” boards while others are led by policy-governing board. Both boards may be called a board of directors, a board of governors or a board of trustees. The responsibility of this board is to provide leadership and direction to the organization, and to govern its affairs on behalf of its shareholders (in the case of a for-profit corporation) or its members (in the case of a non-profit organization). Directors of non-profit organizations are volunteers and are rarely paid for their services, while directors of for-profit corporations are usually compensated.

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

Regardless of the name, size, or type of organization, the role of the director remains fairly constant. Directors and officers of non-profit organizations are responsible for governing the affairs of the organization on behalf of its members. Directors and officers have a relationship of “trust” with the members of the organization, and it is from this trust relationship that certain important legal duties arise.

## 3. Legal duties of directors

The basic responsibility of directors is to represent the interest of the members in directing the affairs of the organization, and to do so within the law. This legal duty is described in statutes (such as the Canada Corporations Act, provincial business incorporation statutes and provincial societies or non-profit organization statutes) and has been expanded and interpreted in the common law.

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

1. The duty of diligence: this is the duty to act reasonably, prudently, in good faith and with a view to the best interests of the organization and its members
2. The duty of loyalty: this is the duty place the interests of the organization first, and to not use one's position as a director to further private interests
3. The duty of obedience: this is the duty to act within the scope of the governing policies of the organization and within the scope of other laws, rules and regulations that apply to the organization

It is important to note that the duties of directors of a non-profit organization are essentially no different than the duties of directors of for-profit corporations. Also, these duties extend broadly: they are owed to the organization as a whole; to the organization's members, participants, clients, staff and volunteers; to other directors; and to anyone else who may be affected by the decisions of the board and the activities of the organization, including the general public.

These three duties are discussed more fully below.

### Duty of diligence

Diligent directors always act prudently and in the best interests of the organization. When exercising their duties as directors, they are expected to exercise the same level of care that a reasonable person with similar abilities, skills and experience would exercise in similar circumstances. And, if a director has a special skill or area of expertise, such as an accountant or lawyer would have, they have a duty to achieve a higher standard of care that corresponds to their professional abilities.

Directors have a responsibility to act cautiously and to try to anticipate the consequences of their decisions and actions before they undertake them. They are honest and forthright in their dealings with each other, with members and with the public. They are well-informed about the activities and finances of the organization. They have an obligation to foresee potential risks inherent in a situation, and to take reasonable steps to manage those risks.

### Duty of loyalty

Directors are required to put the interests of the organization first. These interests will always take precedence over any other interest, including a director's personal interests. As well, directors who are involved in more than one organization may find that they cannot be loyal to both.

Loyal directors will avoid putting themselves in a situation of a conflict of interest, and when this is unavoidable, they will act properly in disclosing the conflict and ensuring that they play no part in discussing, influencing or making decisions relating to that conflict.

Confidentiality is also an important aspect of the duty of loyalty. Directors have an obligation to keep organizational business private, and to not discuss certain matters with people outside the organization. Confidential matters may include information about personnel, clients served by the organization, the organization's finances or legal matters.

A board acts as one entity. Loyal directors support the decisions of the board, even if they might not personally agree with the decision and might not have voted to support the decision in the board meeting.

### Duty of obedience

Nearly all non-profit organizations are "private tribunals" – these are autonomous organizations that have the power to write rules, make decisions and take actions that affect their members and participants. Legally, private tribunals are recognized as having a contractual relationship with their members. This relationship is defined in the organization's governing documents, which include its constitution, bylaws, policies, rules and regulations.

Directors have a duty to comply with the organization's governing documents, and to ensure that staff and committees of the organization do as well. Over time, organizations may move away from their legal purpose and policies may become out of date and no longer reflect the practices of the organization. The duty of obedience extends to ensuring that governing documents remain current and accurate, and overseeing the process that is used to amend and update governing documents.

Directors also have a duty to obey external laws and rules that are imposed upon organizations. A wide gamut of laws and statutes apply to corporations and individuals: the obedient director ensures that the organization complies with these. In particular, an organization that is an employer has many statutory responsibilities to its employees. These responsibilities include paying wages, providing paid time off for holidays, making deductions from wages and remitting these to the government, providing a safe workplace and protecting employees from discrimination and harassment.

## 4. Liability of directors

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

Liability arises in the following three situations:

1. Statute -- a law is broken. The consequences are payment of a fine, having restrictions placed on one's rights or privileges, or imprisonment.

2. Contract -- A contract is breached or violated, where a contract is a legally enforceable promise between two or more parties. The consequences are correcting the breach through some form of performance or service, or financial compensation
3. Tort – an act, or a failure to act, whether intentionally or unintentionally, causes injury or damage to another person. The consequences are payment of a remedy in the form of financial compensation.

Regarding statutes, there are a variety of federal and provincial statutes that impose liability on directors in specific circumstances relating to managing the affairs of the organization. Thus, directors have specific statutory obligations relating to:

- The election and appointment of directors and officers
- Calling meetings of members
- Paying taxes to government and submitting employment-related remittances
- Keeping minutes of meetings of directors and members
- Reporting and disclosing prescribed information about the corporation to authorities
- Paying wages and salaries
- Maintaining a safe workplace
- Activities of the organization that cause pollution or other environmental damage

Regarding contracts, directors are responsible for ensuring that the organization's contractual obligations are fulfilled. This includes contracts with employees and independent contractors.

Regarding torts, directors are responsible for ensuring that they, as well as the organization's volunteers and staff, do not behave negligently. Negligence refers to the duty that we all have to ensure the safety of those persons affected by our actions. Directors, volunteers and staff are at all times expected to act in a reasonably diligent and safety-conscious manner so that others affected by our actions (fellow employees, volunteers, participants, clients, the public) will not face an unreasonable risk of harm.

The concept of negligence also applies to “wrongful acts” – these are errors, omissions, actions or decisions that harm others, not through damaging their property or their physical person, but through interfering with their rights, opportunities or privileges. Wrongful acts relate primarily to how directors govern the organization, manage its funds, supervise its staff and make decisions that affect members, clients and the public.

It is clear, then, that volunteer directors take on a range of legal responsibilities and face many potential liabilities. This can be quite daunting. Recognizing this, it is almost universal practice for non-profit organizations to “indemnify” their directors for liabilities that they might incur in carrying out their duties as a director. To “indemnify” means to put someone back in the same financial position as they were in before. An indemnified director would be compensated for legal fees, fines that were paid under a statute, a financial settlement that resulted from a lawsuit or any other legal obligation that a director was required to fulfill.

Incorporated organizations are required by law to indemnify their directors for such losses. There is no such obligation imposed upon unincorporated groups, but most groups do offer indemnities because it good policy to do so. Keep in mind, however, that the indemnification is only as good as the organization's financial ability to pay it. This is where insurance comes in – and it is discussed in section 6.

## 5. Avoiding liability through risk management

There is risk inherent in everything we do. Volunteers, employees and directors of organizations must always be mindful of risks – this means examining situations cautiously and thinking ahead about the potential consequences of decisions and actions. Most people manage risks most of the time, and they do so instinctively. However, it is always a good idea to take steps ourselves, and to encourage others, to think about risks and risk management more systematically.

The process of risk management is a simple three-part activity. It involves:

1. First, looking at a situation and asking what can go wrong and what harm could result?
2. Second, identifying practical measures we can take to keep such harm from occurring.
3. Third, if harm does occur, identifying practical measures we can take to mitigate its impacts and pay for any resulting damage or losses.

The practical measures that can be used to manage risks fall into four categories:

- Assume the risk – decide that the risk is minor and do nothing
- Reduce the risk – find ways to change people's behaviour or the environment in which people work so that the degree of risk is reduced
- Avoid the risk – choose not to do something
- Transfer the risk – accept the risk but transfer the liability associated with it to someone else through a written contract

Every organization will face different risks and will plan and implement different measures to deal with these risks. The practice of risk management is based in large part on common sense and is linked to the concept of “standard of care”, because the measures the are taken to manage risks are usually those would be taken by any other prudent and reasonable person, having the same skills, knowledge and experience as ourselves. These measures will tend to revolve around training and educating staff and volunteers; enforcing reasonable rules; inspecting and maintaining facilities and equipment; screening and supervising staff; properly documenting meetings and decisions; and meeting all statutory reporting requirements.

The final section of this handbook provides some practical measures that organizations, and individual directors themselves, can take to manage the risks and liabilities faced by a

director. The next section deals with insurance – a common risk management measure and one that is particularly important in minimizing with director’s liability.

## 6. Directors and officers liability insurance

Insurance is one of many techniques used to manage risks – it involves transferring the liability associated with a risk to another party by means of a written contract. In the case of insurance, the party that the risk is transferred to is the insurance company, and the written contract is the insurance policy. Transferring risks through written contracts is a very common business practice.

Directors and officers insurance is like general liability insurance, and covers costs that the directors and officers of an organization might become legally obligated to pay as a result of damages to another party. However, unlike a general liability insurance policy that covers losses arising from physical injury or property damage, directors and officers liability insurance covers only those losses arising from the director’s own “wrongful acts”.

In such an insurance policy, a wrongful act is defined as an error, misstatement, misleading statement, act, omission or other breach of duty by an insured person in his or her insured capacity. The purpose of this insurance is to provide the financial backing for the indemnity that the organization provides to its directors. Directors and officers liability insurance is a fairly recent risk exposure for many non-profit organizations. The risk is not so much that a director will be found guilty of a wrongful act, but simply that there will be an allegation of a wrongful act. Few claims against directors are substantiated and even fewer of these result in large financial awards, but the cost of defending any claim can be significant. This is where this insurance tends to prove its value.

Directors and officers insurance policies vary, and there is no standard level of coverage. Importantly, many of these policies exclude coverage for:

- Directors acting outside the scope of their duties as they are described in this handbook, including any actions that are dishonest, fraudulent or criminal
- Breach of contract, including wrongful dismissal of employees
- Fines and penalties under a statute or regulation
- Complaints under a human rights code, including a complaint of discrimination, harassment or sexual harassment

Insurance is a complex subject, and directors and officers insurance is especially so. For more information on this subject, consult with a lawyer or an insurance representative.

## 7. Incorporation

In this handbook, organizations have been described as being either incorporated or not incorporated. Many associations, societies, community groups and sport clubs are not

incorporated and thus have no legal status. Yet the legal status of an organization can have a significant effect on the potential liability of directors, as described below.

The incorporation of an organization under a federal or provincial statute establishes the organization as a legal entity (almost an “artificial person”) that exists independently as separate and distinct from its members. This legal entity can:

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

An unincorporated organization is not a separate legal entity and has no legal status apart from that of its members. While carrying out their duties on behalf of the members, directors can be held personally and jointly liable for the activities of the organization. For example, an unincorporated entity cannot enter into contracts of its own, so the directors or officers who execute the contract on behalf of the organization might be held to that contract in their personal capacities. Likewise, a third party cannot sue the organization (as it is not a legal entity) but can, and likely would, sue the directors collectively and individually.

An incorporated organization offers directors the protection of what is termed the “corporate veil”. As a separate legal entity, the organization is one step removed from the directors and members. Lawsuits must be brought against the corporation, and directors of such corporations are, to a large extent, protected from liability for actions they took in their capacity as directors.

The minor costs and inconveniences of incorporation are far outweighed the liability benefits that such incorporation provides to the members and directors. Incorporation can sometimes be the best, simplest and least expensive risk management measure for an organization to take.

Incorporation notwithstanding, it must be noted that directors of corporations may be held personally liable, in their capacities as directors, for unpaid wages, holiday pay, employee benefits and taxes. This is of concern to directors of organizations having large numbers of employees, especially if the organization is experiencing financial difficulties and may be unable to meet payroll and tax obligations.

## 8. Protecting yourself as a director

There is no substitute for knowledgeable governance and thoughtful risk management, and the organization that manages its affairs in a conscientious and responsible manner will reduce its directors’ liability risks considerably. Nonetheless, the following practical tips will be helpful to all directors.



Before accepting a directorship with an organization, you should:

- Think about your reasons for becoming a director. Be sure you have the time, interest and commitment to do the job well.
- Learn as much as you can about the organization. What is its mission? What activities does it undertake? How is it perceived in the community?
- Ask for a written job description for the position of director.
- Educate yourself about your legal duties as a director, by reading a handbook such as this one.
- Look at the composition of the entire board, and satisfy yourself that it can govern effectively and provide competent direction to committees, staff and volunteers within the organization.
- Confirm that the organization indemnifies its directors (either through its bylaws, through policy or by means of a written contract) and that it carries directors and officers liability insurance. Ask about the scope of coverage and any exclusions to this insurance.

Once you have accepted a directorship, managing your personal liability risks is an ongoing process. The following guidelines will help you to take steps to manage these risks as they relate to issues such as policy, finances, meetings, personnel, and training.

## Meetings

- Attend meetings, be prepared to discuss the items on the agenda and participate fully in decision-making.
- Provide your reports to the board in written form.
- Ensure that minutes reflect abstentions from votes, votes for and votes against motions.
- If you have any real or perceived conflict of interest, declare it when the issue first arises and do not vote, participate in or influence the decision-making process. Have your disclosure recorded in the meeting minutes.
- Don't rush important decisions. Ensure that board members receive meeting materials in ample time to digest them. If important information is lacking, postpone the decision until this information can be obtained.
- Keep your own personal copies of key documentation and minutes of controversial meetings.

## Finances

- Take an interest in finances by reviewing regular financial reports, and approving and monitoring the organization's annual budget.
- Use a professional, independent accountant to perform an annual audit of the organization's finances.
- Know who is authorized to sign cheques and for what amount.
- Don't be shy about asking questions and seeking clarification on financial matters from staff.
- With the assistance of your auditor, develop a list of statutory reporting requirements and assign a staff person or director to monitor that these requirements are being fulfilled.

## Contracts

- Ensure that all contracts the organization enters into are carefully reviewed by staff or by counsel.
- When the organization partners with other entities on joint projects, or enters into agreements, be sure that all terms and conditions are clearly expressed in a written contract and that risks and liabilities are appropriately shared.

## Policy

- Ask for a copy of the organization's policy manual. If the organization doesn't have a policy manual, develop a work plan for staff (or others, as appropriate) to prepare one.
- Be familiar with the content of the organization's constitution and bylaws. If they are out of date, or no longer adequately reflect the mandate and activities of the organization, then undertake to update them.
- On important matters and for decisions that have the potential to adversely affect someone, ensure that the organization's policies are adhered to as written. If the policy is unsuitable for dealing with the particular circumstance, then take steps to change the policy for the future.
- Commit staff and volunteer time and financial resources to developing risk management policies.

## Personnel

- Ensure that all staff and volunteer positions have written job descriptions.
- Insist that organization develop a clear personnel policy and ensure that staff evaluations are performed at least annually or as required by the policy.
- Be sure that suitable screening measures are in place for those staff and volunteer positions that involve interaction with youth or other vulnerable persons in unsupervised settings.

## Insurance

- Ask for copies of the organization's insurance policies and become familiar with their scope of coverage.
- Consider asking the insurance broker to meet with the Board and make a brief presentation on these policies.

## Training

- Support professional development for staff and training for volunteers.
- Encourage the board to also engage in training. Bring in a board development instructor or a facilitator to help the board improve its effectiveness.
- Offer board members training opportunities in association with board meetings or annual general meetings.
- Commit resources to the development and updating of board and staff orientation materials.
- Leave aside a short portion of every board meeting to allow the board to evaluate its effectiveness in conducting the meeting and making governance decisions.

## General

- If the organization is unincorporated, consider incorporation. As a risk management measure it is well worth the expense and inconvenience.
- If you suspect that something isn't right, go with your intuition and check it out! Be curious. Remember, as a director you will be held responsible for circumstances and situations you ought to have known about, whether or not you actually did know about them.
- Do not speak negatively about the organization to the public. Publicly support the board's decisions, even if you might have voted against the majority of directors.
- If the organization needs to deal with a complex matter in which staff or directors lack expertise, consider the services of an outside professional (for example, lawyer, financial advisor, human resources consultant, risk management specialist, engineer)

## 9. Summary

There are tens of thousands of voluntary organizations and charities in Canada that undertake important work in every community in the country. Those in leadership positions in the voluntary sector are to be applauded and supported for their willingness to take on the responsibilities associated with directorships and the corresponding risks.

The purpose of this handbook is to inform directors of the legal dimensions of their voluntary contribution. It is our view that an informed director is a more confident and competent director.

The most widely available, most effective and least expensive risk management technique is common sense. Voluntary organizations can capitalize on this common sense by recruiting capable board members and well-qualified staff, providing an orientation program for all new people, putting on paper clear job descriptions and sound policies, supporting professional development at all levels of the organization, and creating an organizational culture that emphasizes and rewards risk management thinking and behaviour.

Common sense can be characterized as arising from the mix of knowledge and experience. Most people become directors because they have abundant experience with the organization or the cause to which it is committed, or because they feel that they can bring professional and work-related experience to a rewarding voluntary position. This experience, coupled with the knowledge that can be gained from this handbook, will well-equip director to perform their duties effectively and capably.