



# 1,000 THINGS BOARDS & MANAGERS SHOULD KNOW

## Good Governance Tip #3

### Legal Responsibilities of Directors

#### INTRODUCTION

The law on director's duties is complex, and this should be seen as merely introducing the subject. Expert advice should be sought on particular issues as they may arise.

Director's duties and responsibilities are varied. However, the law has traditionally treated them as falling within two categories; duties of care and skill, and fiduciary duties. A fiduciary is a person who, because of the position they occupy, have the responsibility to act primarily for another's benefit rather than for themselves. Statutes at the provincial and federal levels have dealt with some aspects of director's duties, but much of the material on this subject is part of the common law (i.e. has been generated through judgments in cases before the courts).

Simply stated, the main duty of the board of directors is to manage, or supervise the management of, the affairs of the co-operative. This is provided for in most statutes. In provinces where legislation omits any such reference, the common law provides for this. The terminology used in legislation from jurisdiction to jurisdiction is not consistent. However, differences in terminology probably have little impact on the nature of director's obligations.

The fact that many directors of co-operatives are not remunerated for their efforts does not affect their legal liability. The law imposes legal duties equally upon voluntary directors and those who receive some form of compensation.

There are many individual functions and responsibilities within this general duty. Some are specified in statutes, while others are not. This publication will address both statutory and non-statutory duties. In addition, some director's duties can be found in the constitutions of co-operatives, while others are implied by the operation of the common law.

#### **The Duty to Act With Care & Skill**

The law does not require directors to be experts. It only demands the standard of care and skill which could be expected of a reasonable person. This is not a strict standard. While there is some difference of opinion on the level of care and skill required of directors, this statutory standard is probably lower than that which exists in provinces that have not legislated this particular point. However, the rules regarding diligence impose a greater burden on directors than does the common law. This non-statutory or common law position was laid down for corporations in 1925, and is generally viewed as representing the position for co-operatives.

Under the common law, directors of companies and co-operatives are required to exercise the degree of care and skill that may reasonably be expected from persons of their knowledge and experience. Consequently, much can be expected of an experienced and skilled business person, but little is expected of someone unversed in the ways of business. Bearing in mind the varying degrees of skill possessed by directors of co-operatives, the common law standard would appear appropriate.

Directors do not have to give continuous attention to the affairs of their co-operative, nor need they attend all board meetings (although they should attend whenever possible). As long as there are no grounds for suspicion, duties can be left to those hired to perform them. In addition, directors are not liable for mere errors of judgment.

Although the standard of care and skill required of directors of co-operatives is not very high, there is a risk to directors who do not pay attention to the affairs of their co-operative. Nevertheless, even if it is established that a director breached their duty of care and skill, it may be very difficult to prove that their negligence actually caused the

loss experienced by the co-operative. It is difficult to show that if the director had paid appropriate attention the loss would not have occurred.

Directors must exercise care in selecting the officers of the co-operative. Once chosen, so long as suspicion would not be aroused on the part of a reasonably diligent person, the officers can be left to do their jobs without constant supervision. In particular, directors can rely on documents prepared by professionals, such as accountants and lawyers hired by the co-operative. As the standard of care required of directors is rather low, it is very important for co-operatives to pay particular attention to electing high quality directors.

### **Fiduciary Duties of Directors**

Directors deal with other people's money and property and, as a result, have fiduciary duties to their co-operatives. This means that they will be treated in a similar way as trustees and will be obligated to act with utmost good faith and loyalty to their co-operative. Some provinces have statutory provisions dealing specifically with director's fiduciary duties. In the absence of such provisions the common law applies. Both will be discussed here. Traditionally, these obligations fall into four categories:

Directors must act honestly in the best interests of their co-operative. A co-operative is a legal entity, separate from its members. However, the long-term best interests of the co-operative's members generally constitute the best interests of the co-operative. There must be reasonable grounds upon which the directors feel their actions are in the best interests of the co-operative. For example, measures can be taken to improve the position of the employees by granting them a bonus. This can be presented as good for the co-operative by virtue of bringing about better labour-management relations and better productivity. A recent case in Canada stated that, so long as the interests of shareholders of corporation are not totally disregarded, other interests can be legitimately pursued by the directors. This would presumably hold for co-operatives also. What is in the best interests of a co-operative? A corporation's best interests are the long-term best interests of its shareholders as seen in terms of profit maximization. In a co-operative, the members may be interested in issues other than economic ones, such as the impact of the co-operative on their community and an opportunity to have a say in the operation of the association. For both corporations and co-operatives, it is necessary for directors to balance the long and short-term interests of their organizations.

Directors must only exercise their power for the purposes it was granted. They cannot, for example, issue shares in an attempt to maintain their positions as directors.

Directors must not restrict their discretion to act in the best interests of their co-operative. In other words, they are not permitted to agree with someone outside the co-operative to vote in a particular way at a meeting.

A director must not place themselves in a position which gives rise to a conflict between their interests and those of the co-operative. In practice, this situation can be dealt with by looking at the following common circumstances:

- ★ **MATERIAL CONTACTS.** A contract made between a director, or some person or organization in which the director has a material interest, and their co-operative is voidable at the instance of the co-operative. This means that the co-operative can refuse to be bound by the contract. In addition, the director can be required to forfeit any profits they make from such contracts to the co-operative, even if the contract in question benefits the co-operative. The rationale is that the director cannot look after the co-operative's interests and their own interests when they are contracting with each other, or where the director has some other personal interest in the contract.

Such contracts are prohibited neither by common law nor by statute. Rather, the law attempts to control these contracts by providing mechanisms for directors to obtain the approval of the co-operative for such activity. As a general rule, directors should make a full and frank statement of any contracts that put them in conflict with their co-operative as soon as the conflict arises.

A director may not take part in discussions or vote on contracts in which they have an interest, unless the contracts involve obligations undertaken by the director for the benefit of the co-operative, remuneration for the

director or a contract of indemnity or insurance to protect the director from responsibility for actions carried on in the course of their duties as a director.

The disclosure requirement can be satisfied by a continuing blanket disclosure of the director's contracts to the board of directors. The common law dictates that the only course open to a director who is interested in a contract is to make full disclosure of their interest to the members, and to have the contract ratified by the general meeting.

Most statutes include the disclosure requirement contracts of directors entered into in the capacity as members. For instance, the Co-operative Associations Act, which is most precise on this point, excludes marketing contracts, service contracts, or contracts to purchase goods from the association that are 'similar to contracts entered into by the association with members who are not directors thereof'.

The result of making the disclosure is that the contract, provided it is fair and reasonable for the co-operative, will not be voidable as a result only of the director's interest in it. Also, the director will be able to retain profits they may experience from the contract. On the other hand, where these disclosure requirements are not satisfied, the contract can be set aside at the instance of the co-operative or one of the members. This is the common law position and would apply in every province where the appropriate statutory or common law disclosure rules had not been complied with.

- ★ Misuse of Confidential Information. A director must not use any property, information, or opportunity belonging to the co-operative for their own profit. A director may find themselves in possession of information available only to directors. If the director experiences a profit as a result of using this information, they can be required to forfeit it to the co-operative. Similarly, if a co-operative is considering a particular business venture on their own behalf, profits made as a result can be required to be forfeited to the co-operative. It is a particular example of a conflict of interest between the director and their co-operative.

'Insider trading' in co-operatives has received more attention in recent statutes. It involves the use of information that comes to the director's attention as a result of being a director. The problem is more acute in corporations, and the precautions taken in regard to co-operatives are less extensive. The situation may arise, however, where a director holding a large number of shares in a co-operative may, as the result of information available to them as a director, arrange to make a profit which they should not be entitled to retain.

## **LEGISLATED DUTIES & POSSIBLE PROTECTIONS FROM LIABILITY**

### **Specific Statutory Duties**

The various co-operative statutes place specific responsibilities on directors. In addition, they set out certain duties to be performed by the co-operatives themselves. As co-operatives can only act through their functionaries, the obligation to perform these duties falls upon the directors in fulfillment of their duty to supervise the management of the co-operative. Relevant statutes should be perused to ascertain these duties in detail. However, some general comments can be made to indicate the sort of duties involved.

Naturally, directors and co-operatives must comply with the statute under which they are incorporated and with regulations passed under it, as well as with the articles and by-laws of the co-operative. They must hold appropriate meetings and present financial statements and auditor's reports to the annual meetings of members. They must file annual returns and respond to requests from the Registrar.

### **Protection for Directors**

To what extent can directors be protected or relieved from their responsibility and receive payment for expenditures and loss incurred as the result of legal action being taken against them in their capacity as directors? Again, the legislation is not uniform. Most statutes make no reference to this point.

Consequently, the common law position applies and permits co-operatives to relieve their directors from responsibility for breaches of duty and indemnify them against liability and expenditures. Generally, the statutes that contain provisions dealing with these matters limit such relief to circumstances in which the director acts in good faith.

## CONCLUSION

Co-operatives need to pay particular attention to electing directors and to ensuring that those elected are equipped to deal with the challenges of running the co-operative's affairs. The level of care and skill required of directors by the law is not high; however, they do have to be diligent in their actions or run the risk of being held accountable for any losses their lack of care gives rise to. Director's fiduciary duties are strictly enforced, but directors may be relieved from their performance by the co-operative.

The statutes of each province, and of Canada, deal differently with director's duties, and directors and their co-operative should consult the Acts for the specific rules applicable in their region.

The question of legal responsibilities of the co-operative or the board of directors as a whole is beyond the scope of this publication. Legal advisors should be consulted when the co-operative's legal position is in question. However, boards of directors would be well advised to pay attention to careful documentation of board decisions, written manager job descriptions, and contract or employment, as well as systematic, well documented treatment of any issues having potential legal consequences.

For further information on this and other related topics, as well as many co-operative development subjects such as governance, finance and marketing, strategic planning, management, etc, contact the Nova Scotia Co-operative Council at the address below. Our knowledgeable staff of Business Development Officers, located in Truro, Sydney, and Yarmouth are available to assist you in all areas of co-operative development. You can also visit us on the web at [www.nsko-opcouncil.ca](http://www.nsko-opcouncil.ca).



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