

SERVING AS A DIRECTOR
OF A VALUE-ADDED
AGRICULTURAL CO-OP

THE LEGAL
BASICS

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INTRODUCTION

Most of my work as a lawyer is with societies and co-operatives, including their boards of directors. It is not uncommon for a director to call me by phone, to quickly describe a problem or challenge at the organization and then ask “We won’t be personally liable for this, will we?”

There seems to be heightened anxiety among directors on this issue, perhaps due to the scandalous frauds and failures of organizational governance involving Worldcom, Enron, Hollinger, and other companies. The images of corporate leaders, including Canadians and former Canadians, being sent to American jails, are powerful and alarming to many board members.

My answer to questions about personal liability usually goes something like this:

- First, potential personal liability for directors is completely dependent upon the specific circumstances and facts of each case. To give a proper answer requires full and careful review of the facts, not a two minute phone conversation.
- Second, there are lots of different ways that directors can become personally liable for problems that arise at co-ops.
- Third, avoiding personal liability as a director involves paying attention to legal duties and taking some sensible precautions.

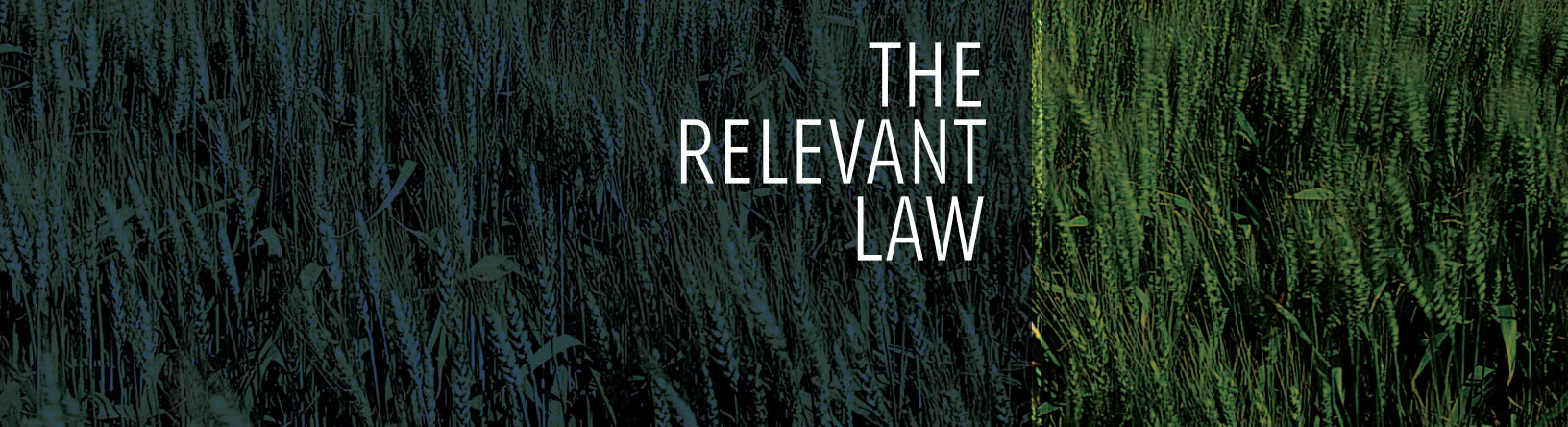
This paper is an attempt to address anxiety among directors by providing information and practical guidance on the nature of these risks and the legal duties and precautions that can help directors of co-ops in Canada avoid personal liability.

The basic principles discussed here are essentially the same as those that apply to directors of business corporations and societies. Indeed, the bulk of the case law deals with business corporations, for they are more numerous than co-ops. Many of the legal lessons from those cases apply to value-added agricultural co-ops, as well as other types of co-ops.

Although the subject matter is complex and it can be intimidating for some directors, my hope is that those who read this paper will conclude that directors’ risks can be managed and the duties fulfilled, and that a leadership role within a co-op is not something to avoid out of fear of exposure to personal liability.

This paper is not a substitute for a legal advice on a specific problem. It distills key legal concepts, but it does not deal with all of the details and complexities of this field of law or with the endless combinations of facts that can constitute legal problems. Seek legal advice if your co-op has a problem that it cannot resolve itself.

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THE RELEVANT LAW

Regrettably, there is no single Act of Parliament that describes all of the risks and duties associated with serving as a director of a co-op in Canada. Some Canadian co-ops are incorporated under the federal *Canada Cooperatives Act*. There are provisions within that *Act* that address potential liabilities and duties of directors. Other co-ops are incorporated under provincial or territorial co-operative legislation, each of which addresses director liabilities and duties in its own way. See Appendix B for links to Canadian co-op legislation.

The incorporation legislation does not provide the complete picture. There are also provisions in many different federal and provincial statutes that impose requirements and create the potential for directors to be found personally liable or guilty of offences. We will look at some of this legislation below.

In addition to legislation, there are legal rules that have been developed by the courts over the years that apply to co-op directors. We will also examine relevant principles from the common law in some detail.



INCORPORATION

The act of incorporating a co-op has some fundamental implications. The first consequence of incorporation is that it creates **a new legal being** with the rights, powers, and privileges of a natural person or an individual of full capacity. The individuals or organizations that become the members of this legal being elect a board of directors that is given the responsibility and authority to manage the co-op's business in accordance with the applicable legislation and the rules adopted by the members of the co-op.

A second fundamental consequence of incorporation is **limited liability**. This concept applies to members in their capacity as members. It means that members are protected from being held responsible for the debts or liabilities of the co-op. All that members risk is their membership share purchase fee, the price of any investment shares they may have purchased, and any loans they may have made to the co-op.

It is critical to recognize that limited liability does not protect directors acting in their capacity as directors. Directors can be held liable for their actions or omissions. At one time, the courts extended the protection of limited liability to directors as well as members. Over recent decades, legislatures and the courts have been increasingly willing to "pierce the corporate veil" in order to prevent criminal, dishonest, reckless, or negligent directors who have caused harm to hide from criminal or civil justice behind that veil.

A third fundamental consequence of incorporation is **collective authority**. The powers of the directors are powers of the entire board, not of directors individually. The board must function as a team in managing or overseeing the affairs of the co-op. It may delegate tasks to committees or individual directors, but the authority ultimately remains with the board as a whole.

POTENTIAL PERSONAL LIABILITY

Directors of co-ops can be held liable to the state, to the co-op itself, to employees, to co-op members, to customers, and to the general public. Unfortunately, there is no empirical data on the frequency or nature of legal actions against co-op directors or the outcomes of those cases. My unscientific observations and review of case law have led me to conclude that it is very rare for co-op directors to be found personally liable or guilty of offences in their capacity as directors – but the potential does exist.

CRIMINAL LIABILITY

It is possible for directors of Canadian co-ops to be prosecuted, convicted, and sent to prison for offences under the *Criminal Code of Canada* – fraud or breach of trust, for example. Criminal prosecutions of this sort are also rare in Canada, but criminal charges could be laid if co-op directors perpetrate any crime, authorize it, or knowingly allow it to occur within the organization.

I have been unable to find a reported Canadian case of a co-op director being convicted of a criminal offence in his or her capacity as a director. A Canadian example of a criminal fraud conviction of a corporate president and director is the case of Brian Slobogian of Eron Mortgage Corp. in Vancouver, who was sentenced to six years in prison.¹ Charges of criminal negligence causing bodily harm were also laid against a senior official at the Canada Red Cross over the tainted blood tragedy, but the doctor charged was found not guilty after a trial.² The Judge concluded that the doctor's conduct did not amount to wanton and reckless disregard – the standard for a criminal conviction for this offence.

¹ See the CBC news report at: <http://www.cbc.ca/money/story/2005/03/29/eron-050329.html> (Retrieved April 3, 2008).

² <http://www.thestar.com/printArticle/262563> (Retrieved April 3, 2008).

THE INCORPORATING LEGISLATION

Each of the co-operative acts in Canada includes provisions that create potential liability for directors. There are offence provisions that, if violated, can result in fines or imprisonment. The following passage from the *Canada Co-operatives Act* highlights a common concern in all of the incorporation acts – honesty and accuracy in the filing of reports to government regulators. Section 349(3) of that *Act* states:

A person is guilty of an offence punishable on summary conviction if the person knowingly makes or assists in making a report, return, notice or other document required by this Act or the regulations to be sent to the Director or to any other person that

- (a) contains an untrue statement of a material fact; or
- (b) omits to state a material fact required in it or necessary to make a statement contained in it not misleading in the light of the circumstances in which it was made.

These offences can result in fines of up to \$2,000, six months in prison, or both.

In the case of the Ontario *Co-operative Corporations Act*, knowingly making or filing false statements or documents to or with the Minister or the Superintendent of Financial Services can result in "a fine of not more than \$10,000 or to imprisonment for a term of not more than one year, or to both."³

Many things are offences under the federal, provincial, and territorial incorporating legislation for co-ops. Offences include: incomplete record-keeping; incomplete filings with the regulator; improper redemption of shares; failure to disclose conflicting personal interests; mismanagement of proxies; misuse of confidential information; improper conduct in relation to the co-op's auditor; and offering employment as an inducement to invest in the co-op. Each incorporating act treats these offences differently.

In addition to the offence provisions, the incorporation statutes expressly state circumstances in which directors can be liable to the co-op itself. For example, the Newfoundland and Labrador *Co-operatives Act* states:

42. (1) Where the directors, without the approval of the membership, vote for, authorize or approve
- (a) the payment of remuneration to directors;
 - (b) an acquisition or purchase of common shares other than the co-operative's own shares;
 - (c) the purchase of shares in the co-operative;
 - (d) the payment of a dividend or interest on shares;
 - (e) a loan or guarantee or the giving of financial assistance;
 - (f) a payment of an indemnity to a director or a former director; or
 - (g) an act contrary to this Act or the articles or by-laws of the co-operative,
they are jointly and individually liable for loss or damage suffered by the co-operative.
[underlining added]

"Joint and several" liability means that the co-op could sue one, some of the responsible directors, or all of them, at the co-op's option.

³ Section 173(1)

A third form of liability commonly found in the incorporating legislation (or in employment standards legislation or regulations) is potential liability to employees, as illustrated by this passage from the Alberta *Cooperatives Act*:

79(1) The directors of a cooperative are jointly and individually liable to employees of the cooperative for all debts not exceeding 6 months' wages payable to each employee for services performed for the cooperative while they are directors.⁴

It is possible, in some circumstances, to be fined and imprisoned for offences, and to be held financially liable to the co-op or employees. In British Columbia, s. 202 of the *Cooperative Association Act* states:

(1) A legal proceeding, conviction or penalty for an offence under this Act does not relieve a person from any other liability.

In other words, a director who failed to disclose to the co-op a personal interest in a contract with the co-op could, in theory anyway, be fined, imprisoned, and ordered to repay the co-op for any loss it has suffered. Conflicts of interest are discussed in more detail below.

It is very important for all directors of co-ops to become familiar with their own incorporating legislation. What may be an offence or source of liability in one province or territory may not be in another province or territory or under the federal statute. The legislation varies, so study your own statute carefully. You will find links to the incorporating legislation in your province or territory in Appendix B.

OTHER STATUTORY LIABILITY

There is a wide range of federal and provincial legislation that creates offences and other potential liability for directors of co-ops and other organizations.⁵ It is impossible to canvass all of it here. Instead, some of the major risks stemming from legislation are highlighted.

Income Tax Act (Canada)

This complex piece of legislation explicitly establishes liability for directors to pay income tax deductions for employees. This liability is joint and several, which means the Canada Revenue Agency may pursue all, some, or any one of the directors to recover the outstanding funds. In addition, this *Act* makes it an offence to make false statements in tax returns. Directors face potential fines or jail for offences of this kind.

Canada Pension Plan

This statute requires employers to remit to the federal government premiums for employee pensions. If a co-op fails to make these contributions, the directors can be personally liable.

Excise Tax Act

This *Act* creates the GST, and makes directors personally liable if a co-op does not collect and remit the tax. Directors of co-ops need to ensure that this essential encumbrance of business – the GST – is competently managed and accounted for.

⁴ Section 79 of the Alberta Cooperatives Act goes on to describe additional conditions that must be met for this liability to employees to materialize. Again, the Act needs to be reviewed thoroughly in order to fully understand the nature of this risk.

⁵ Toronto charity and non-profit lawyer Terrance Carter estimated in a 2007 Risk Management Symposium that "Directors of not-for-profit and charitable corporations may be found liable for their actions under more than 200 statutes or regulations (in Ontario and federally)." See http://www.carters.ca/pub/seminar/charity/2007/tsc1123a_files/frame.htm#slide0132.htm (Retrieved March 12, 2008).

Excise Act, 2001

This *Act* imposes excise duties and controls on tobacco, beer and spirits, including ethanol, manufactured in Canada. Part 6 of the *Act* deals with "Offences and Punishment," and is extensive.⁶ It provides that directors of organizations that violate the *Act* can be liable for unpaid duties, subject to fines, imprisonment, or seizure, forfeiture or order to destroy products.

Anyone, including a co-op, interested in producing ethanol, even on a small scale, must be licensed under this *Act* and its regulations. Fully describing the licensing process and requirements would require another paper, but the Canada Revenue Agency Web site includes a comprehensive description of how to become a licensee and how to comply with the legislative and regulatory requirements.⁷ To avoid inadvertent violations of this *Act*, the best advice I can provide is to contact the nearest Regional Excise Duty office⁸ before beginning ethanol production.

Securities Legislation

The Canada *Co-operatives Act* and co-op legislation in several provinces allow co-ops to raise capital by selling investment shares. This is a relatively new financial tool for co-ops, intended to make it easier for co-ops to raise capital.

Issuing investment shares brings co-ops into the complex world of securities law. This is a field of detailed legislative and regulatory requirements with pitfalls and potential liabilities that vary from jurisdiction to jurisdiction. It is impossible to accurately summarize securities law here. Securities law violations can result in co-op directors being charged with offenses or being found civilly liable to investors in a variety of ways. For example, the Ontario *Securities Act* creates potential director liability for: misrepresentation in a prospectus, offering memorandum, or circular, or failure to disclose a material fact or change.⁹

Issuing investments shares should only be done with the help of an experienced securities lawyer, for the risks of director liability are substantial and great care needs to be taken.

Occupational Health and Safety and Workers' Compensation Legislation

Each province and territory has established its own workers' compensation and workplace safety regimes. These are generally complex, but a common theme is the potential for the directors of employer organizations, including co-ops, to be personally liable for failures to remit premiums to the appropriate government bodies. Moreover, directors who allow workplace safety standards to be violated by their co-ops are exposed to the risk of substantial fines and imprisonment. This is an area where co-op directors need to be particularly attentive to the details of the applicable legislation and regulations. Employee and public safety must be taken very seriously.

Environmental Legislation

Directors of co-ops that engage in activities that could cause environmental harm need to be aware of increasing risks of personal liability from federal and provincial legislation.

⁶ See http://laws.justice.gc.ca/en/showdoc/cs/E-14.1/bo-ga:l_6/en#anchorbo-ga:l_6 (Retrieved April 3, 2008).

⁷ See <http://www.cra-arc.gc.ca/menu/EXMS-e.html> (Retrieved April 3, 2008).

⁸ See <http://www.cra-arc.gc.ca/E/pub/em/edm1-1-2/edm1-1-2-e.html> (Retrieved April 3, 2008).

⁹ See <http://www.canlii.org/eliisa/highlight.do?text=securities+act&language=en&searchTitle=Ontario&path=/on/laws/sta/s-5/20080318/whole.html> (Retrieved March 12, 2008).

If, for example, a leak occurs at a bio-fuel co-op and a toxic substance enters a nearby stream, the co-op's directors may be charged with offences under the federal *Fisheries Act* or provincial legislation directed at controlling water pollution and protecting drinking water.

The federal *Fisheries Act* provides that:

78.2 Where a corporation commits an offence under this Act, any officer, director or agent of the corporation who directed, authorized, assented to, acquiesced in or participated in the commission of the offence is a party to and guilty of the offence and is liable on conviction to the punishment provided for the offence, whether or not the corporation has been prosecuted.

Penalties on conviction can be a fine not exceeding \$500,000 or imprisonment for up to two years, or both. The various provincial statutes protecting drinking water and controlling water pollution also include penalties provisions that can apply to co-op directors.

Another significant piece of environmental legislation is the *Canadian Environmental Protection Act*. It provides that directors of corporations (including co-ops) who breach the *Act* can be sent to prison or fined up to \$1 million.¹⁰

Canada Agricultural Products Act¹¹

This statute says that its purposes are to "regulate the marketing of agricultural products in import, export and interprovincial trade and to provide for national standards and grades of agricultural products, for their inspection and grading, for the registration of establishments and for standards governing establishments." Anyone, including co-ops, wanting to export cheese or butter, for example,¹² internationally or to other provinces or territories, would need to comply with the many grading, sanitation, facility standards, and other requirements detailed in the *Act* and the regulations created to support the *Act*. It expressly states that directors can be held responsible for offences under the *Act*, and subjected to a "fine not exceeding \$250,000 or to imprisonment for a term not exceeding two years, or to both." Failure to meet sanitation standards at a food processing facility where food is prepared for export could be a contravention of the *Act* that could trigger charges.

Directors of co-ops involved with food product exports should become familiar with this *Act* and the related regulations.

BC Agri-food Choice and Quality Act¹³

This *Act* enables the provincial government to establish various certification, labelling and promotional programs and standards. Violation of the *Act*, including denying a government inspector access to a food production operation can amount to an offence punishable with a fine up to \$5,000, up to 6 months in prison, or both, and an order for the payment of compensation or restitution to the government or another party for any losses suffered. Check your jurisdiction for similar legislation.

¹⁰ <http://laws.justice.gc.ca/en/C-15.31/> (Retrieved March 12, 2008).

¹¹ <http://laws.justice.gc.ca/en/showdoc/cs/C-0.4///en?page=1> (Retrieved March 12, 2008).

¹² There are regulations under this Act that specifically address the export of dairy, honey, maple, and organic products, livestock and poultry, eggs, fresh fruit, and vegetables.

¹³ http://www.qp.gov.bc.ca/statreg/stat/A/00020_01.htm#section8 (Retrieved March 12, 2008).

TORT LAW

Torts are civil wrongs for which injured parties can sue for compensation. Some torts are intentional (for example assault or defamation), while others are the result of carelessness or negligence (for example, negligent maintenance of a building).

Here are two examples that illustrate how a co-op director could be sued for damages under tort law:

1. A co-op is in a dispute with a contractor over the construction of a greenhouse complex, which is behind schedule. A director of the co-op writes an e-mail to a co-op member stating that "the project is delayed because the builder is incompetent and appears to have a drug problem."

If these allegations are false, the director could be sued by the builder for defamation and the director could be ordered to pay damages to the builder for the harm done to his reputation.

2. The co-op holds a public open house to show off the new greenhouse complex, but on orders from one of the co-op board members, co-op staff do not fill in or place barricades around an irrigation trench outside the main door. A visitor to the open house falls in the trench and breaks an arm. The injured visitor may be able to sue the co-op and the director who made the order for negligence.

Both of these examples highlight a critical requirement for personal liability – personal involvement in the wrongdoing by the director in question. Directors with no such personal involvement in the wrongful act or omission would not be personally exposed to the risk of a lawsuit. Failure to prevent wrongful acts that are brought to a director's attention in advance could be sufficient personal involvement to trigger liability.

The concept of vicarious liability should be mentioned here. It provides that an organization, including a co-op, can be liable for the wrongful acts of its employees.¹⁴ But directors who have had no personal involvement in the wrongful acts will not be personally liable.

¹⁴ A helpful paper by Don Bourgeois entitled "Vicarious liability for wrongful acts of employees of charitable and nonprofit organizations" is available at <http://www.charityvillage.com/cv/research/rlegal12.html> (Retrieved March 12, 2008).

CONTRACT & EMPLOYMENT LAW

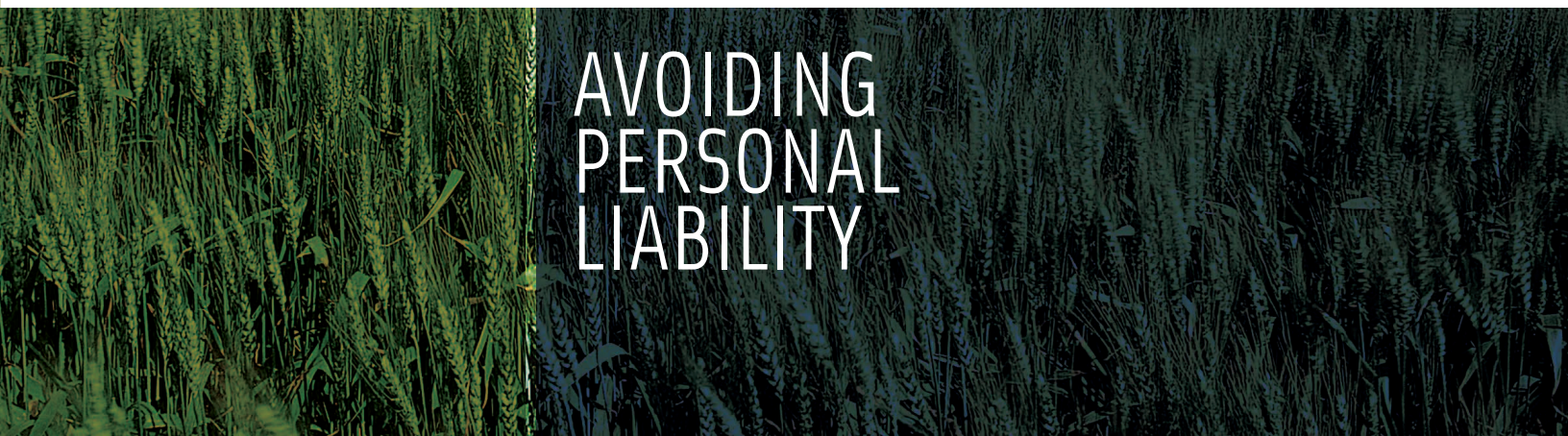
The common law provides protection to directors if there is a breach of contract, caused by a co-op, between the co-op and a party contracted to the co-op, such as a former employee. The former employee would be able to sue the co-op itself, because the co-op is a party to the contract, but the individual directors were not parties to the contract, so they could not be sued for breach of contract. This is an example of the application of the contract law principle of privity.

However, if in terminating the employment contract, directors acted with malice against the former employee, or were motivated by personal gain rather than by the best interests of the co-op, they could be sued for the torts of inducing a breach of contract, conspiracy, or perhaps intentional infliction of mental or emotional distress, or defamation.¹⁵ Here is an example:

The board of directors of a co-op decided to terminate the employment of the General Manager. The board of directors passed a resolution terminating the employment contract and offering no notice or severance payment. At the grocery store lineup, one of the directors was overheard telling some friends that the former General Manager "has no business skills and often did not tell the truth to the board." If there was no legal "cause" for termination, the former General Manager could sue the co-op for breach of contract and if the allegations made in the grocery store are false, the former General Manager could sue that director for defamation and possibly other torts as well.

In my experience, most lawsuits or threats of lawsuits involve employment situations. Directors would be wise to become familiar with the principles of employment law and to be very careful in their handling of employment issues. It is prudent to obtain legal advice before actions are taken that impact employees.

¹⁵ For a more detailed analysis of relationship between contract, tort and the directors' duties see: Bruce E. McLeod, Personal liability of corporate officers and directors for wrongful dismissal. <http://www.cle.bc.ca/CLE/Analysis/Collection/01-5028901-liabilitydirectors?practiceAreaMessage=true&practiceArea=Labour%20and%20Employment> (Retrieved March 12, 2008).



AVOIDING PERSONAL LIABILITY

We have reviewed many of the ways that co-op directors can potentially become personally liable for problems. It's time to move from the scary to the encouraging – the strategies for avoiding personal liability.

MANAGING THE RISKS

The best way to avoid personal liability as a director is to skillfully manage the problems that, if mishandled or untended, can lead to charges or lawsuits. This is the “due diligence defence.” The federal *Fisheries Act* referred to above provides a summary:

Due diligence defence

- 78.6** No person shall be convicted of an offence under this Act if the person establishes that the person
- (a) exercised all due diligence to prevent the commission of the offence; or
 - (b) reasonably and honestly believed in the existence of facts that, if true, would render the person's conduct innocent.

“Exercising due diligence” means fulfilling the duties of directors that are described below. It is an intuitive concept that includes:

- looking out for potential problems, harm, or loss;
- taking steps to prevent the harm or loss;
- minimizing harm or loss if it does occur; and
- generally being honest and applying good judgment.

THE DUTIES OF DIRECTORS

Fiduciary Duties

Fiduciary duties arise from trust relationships. Co-op directors deal with the property and assets of the co-op and are expected by the common law and in some jurisdictions by legislation¹⁶ to fulfill the duties and standards of fiduciaries. They can be distilled as follows:

Co-op directors must:

- act honestly and in good faith;
- be loyal and act in the best interests of the organization;
- avoid conflicts of interest; and
- place the interests of the organization ahead of their own interests.

It is important to note that fiduciary duties are owed to the co-op itself, not its members, investors, employees, creditors, or customers. While the directors may take into account the impacts of board decisions on these other important stakeholders, they must act with the co-op's interests paramount in fulfilling their fiduciary duties.

Conflicts of Interest

A critical element of the fiduciary duties of co-op directors is to avoid and manage conflicts of interest. In some provinces, British Columbia and Alberta, for example, the co-op legislation addresses this duty in detail. In others, New Brunswick, for example, the legislative guidance is sparse, and the common law must be relied upon.

The popular understanding of the concept of "conflict of interest" has become stretched and increasingly complex in recent decades. From the corporate or co-op law perspective, the concept is quite straightforward. While the details in each co-operative act vary, the key principles are these:

1. A co-op director will be in a conflict of interest if he or she has a "material interest" in a proposed contract or transaction with the co-op itself. A conflict will exist if the contract in question involves the director individually, a business the director owns or directs, or a family member or business of a family member. There is no precise definition of "material" in this context. It is generally interpreted to mean sufficiently important to create a benefit for the director. It would exclude exchanges of a minor or trivial nature.
2. A co-op director must fully disclose to the co-op the nature and extent of his or her conflicting interest. This disclosure should be made in writing to the full board of directors and as soon as the conflict arises or the director in conflict becomes aware of the conflict. Alternatively, if the disclosure is made verbally at a board meeting, the director in question should request that the disclosure be entered into the minutes of the meeting.

¹⁶ For example, see BC Cooperative Association Act s. 84 or s. 212(1) of The Cooperatives Act in Manitoba.

3. Once the conflict is disclosed, the director in question must not participate in any vote by the co-op board of directors relating to the contract or transaction. The legislation varies as to whether the director in question may be present for discussion of the contract, but in all cases it is clear that the director in conflict must not vote on the issue. To “recuse” or voluntarily remove oneself from deliberations on the issue is generally the best approach to take.
4. If the director properly discloses the conflict and the contract is fair and reasonable to the co-op, the director in question is entitled to retain the profits from the contract.
5. If the director fails to disclose an interest in a contract or transaction with the co-op, he or she may be liable to the co-op for any profits the director made. The co-op, a member, or an investment shareholder may seek a court order that the contract be set aside or deemed void, and the director’s profits paid to the co-op. The court will consider all the facts, including whether the contract was fair and reasonable to the co-op, in deciding what should be done in relation to the contract. The contract is not automatically void.
6. Conflicts like this can be brought to the members of the co-op to resolve in advance. While the legislation varies, the principle is that the members of the co-op may, usually by special resolution, approve or reject the contract or transaction. The members can approve even if the conflict was not properly disclosed to the board of directors.
7. Disclosure of the conflict by the board of directors to the members of the co-op is required by some of the acts (BC, for example). Subsequent ratification or confirmation of the contract by the members will allow the director in question to keep the profits from the contract. If the members do not approve the contract, it is void and the profits must be surrendered to the co-op.
8. It is not a conflict for directors to vote on contracts that are common to all directors or members, such as remuneration, insurance, indemnification, or dividends.
9. It is very important to check the applicable incorporation legislation to see how it addresses conflicts of interest. Similarly, the bylaws or rules of the co-op must be reviewed to see if specific conflict provisions have been adopted.

Here is an example of conflict of interest.

A food processing co-op is negotiating the purchase of building to house its expanding business. The building is owned by a corporation. The spouse of one of the co-op directors owns a 50 percent interest in that corporation. The co-op is unaware of this connection.

Clearly, the co-op director whose spouse has a financial interest in the building is in a conflict of interest. The co-op director stands to benefit financially if the co-op pays a high price for the building and this conflicts with the director’s legal obligation to place the co-op’s interest first.

The co-op director should immediately and fully disclose this interest in the building to the co-op board of directors and then step away from the negotiations and decision-making regarding the building. Failure to do so could result in the subsequent contract being challenged and the director being ordered to repay profit to the co-op.

Common Law Duties

There is no single definitive list and description of the common law duties of directors. Various cases, texts, and authorities categorize and express the duties somewhat differently. In a nutshell, they include:

a. Duty to Manage

Much has been written about governance models and the relationship between boards of directors and staff. There is insufficient space here to canvass governance theory, but the fundamental legal principles should be restated – board members are ultimately responsible for the management of all aspects of the co-op's business affairs on behalf of the co-op's member. Directors may delegate management functions to staff, but they are not absolved of this responsibility.

Directors are accountable to the members of the co-op who elect them. The members may remove directors and the members may adopt rules or bylaws that govern how the board carries out its management functions.

b. Duty of Care

Directors of co-ops must take care in fulfilling their duties. Perhaps surprisingly, there are two different standards of care, depending on the jurisdiction. The old common law standard of care is subjective. With this test, directors must meet *the standard of conduct reasonably expected of a person of such knowledge and experience as the specific director*.

This subjective test means that directors with high levels of relevant experience (lawyers, accounts, experienced business persons, co-op developers) are expected to meet a higher standard of care than directors with limited experience or less relevant education.

This subjective standard applies to co-ops in Quebec, Nova Scotia, Prince Edward Island, New Brunswick, Yukon, Northwest Territories, and Nunavut.

Other jurisdictions have passed legislation that adopts an objective test. For example, the Newfoundland and Labrador *Co-operatives Act* states:

41. (1) A director or officer of a co-operative, in exercising his or her powers and performing his or her duties, shall
 - (a) act honestly, in good faith and in the best interest of the co-operative;
 - (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances; and
 - (c) comply with this Act and the articles and by-laws of the co-operative.

This objective approach does not consider the background or experience of specific directors, but expects all to meet the reasonably prudent person test. Some argue that the subjective test deters people with particular skills and experience from serving as directors. Conversely, the objective test may be difficult for some inexperienced or less skilled directors to meet.

Which test is better is itself debatable. The legislative trend is toward the objective test, which is likely easier for courts to apply, but there appears to be no rush to replace the old common law test in all provinces. In addition to Newfoundland and Labrador, the objective test has been added to the *Canada Cooperatives Act*, and the co-op legislation in British Columbia, Alberta, Saskatchewan, Manitoba, and Ontario.

Complicating the subjective v. objective test issue further is the fact that some of the case law has concluded that the *Income Tax Act* and the *Excise Tax Act* create a test that "has both an objective and a subjective aspect."

In the case of *Smith v. R.*, the Federal Court of Appeal¹⁷ made these interesting observations:

In assessing the objective reasonableness of the conduct of a director, the factors to be taken into account may include the size, nature and complexity of the business carried on by the corporation, and its customs and practices. The larger and more complex the business, the more reasonable it may be for directors to allocate responsibilities among themselves, or to leave certain matters to corporate staff and outside advisers, and to rely on them.

The inherent flexibility of the due diligence defence may result in a situation where a higher standard of care is imposed on some directors of a corporation than on others. For example, it may be appropriate to impose a higher standard on an "inside director" (for example, a director with a practice of hands-on management) than an "outside director" (such as a director who has only superficial knowledge of and involvement in the affairs of the corporation).

The bottom line appears to be that whether a co-op director has met the standard of care can only be determined after a full review of all of the facts.

c. Duty of Knowledge

Directors are not tested for their knowledge before joining a co-op board, but they do have a duty to become knowledgeable about the co-op. This includes becoming familiar with the co-op's incorporation documents (articles of association or constitution), its bylaws or rules, and its key policies. They should also learn about the co-op's business activities and markets, its history and its future plans. It is good practice for boards of directors to ensure that all new directors receive a comprehensive orientation, and that board education is a regular part of the co-op's annual cycle.

d. Duty of Prudence

This duty obligates co-op directors to apply their best judgment to decisions they make. To be prudent, a director must be practical and "act cautiously and anticipate any probable consequences of any course of action that the organization may choose to undertake."¹⁸ Directors are not expected to be flawless in their decision-making, but they should turn their minds to each issue and do their best. Again, the individual expectation is either objective, the *reasonable person* test, or subjective, *the standard of conduct reasonably expected of a person of such knowledge and experience as the specific director*, depending on the jurisdiction.

¹⁷ <http://decisions.fca-caf.gc.ca/en/2001/2001fca84/2001fca84.html> (Retrieved April 3, 2008).

¹⁸ Kelly, H. M. (2004). *Duties and responsibilities of directors of not-for-profit organizations* (2nd ed.). Toronto, ON: Canadian Society of Association Executives.

The expectation to maintain appropriate levels of confidentiality can be considered a subset of the duty of prudence. A prudent director protects information that should be kept confidential in the best interests of the co-op. Alternatively, protecting the confidentiality of the co-op could be treated as a stand-alone director duty. The balance between confidentiality and full reporting to members can be a challenge, and should be treated carefully.

e. Duty of Diligence

This duty is very similar to the duties of knowledge and prudence. It generally refers to the expectation that directors will be attentive to their roles and to the business of the co-op. It means being an active director by attending and participating in board and committee meetings, preparing properly, asking questions, raising concerns, contributing ideas and views, and following up on decisions and issues as necessary. Meeting minutes, reports, financial statements, and other relevant documents should be read carefully and questions asked if clarification or more information is needed.

A diligent director does not merely rubber-stamp recommendations from staff. Instead, he or she encourages the co-op to constantly improve its performance. Ideally, there should be a creative tension between and among diligent directors and staff that drives improvement.

f. Duty of Obedience

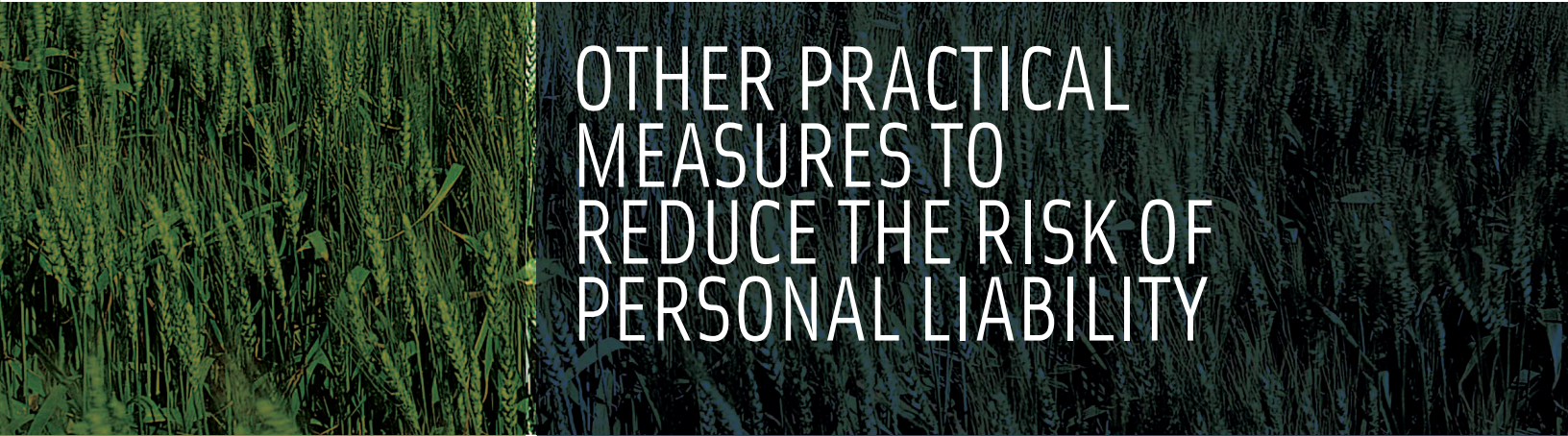
This duty refers to the obvious legal fact that directors must comply with the law and government regulations that apply to the co-op, and to the co-op's own internal rules or bylaws, policies and decisions of the members. The accountability of the board to the co-op's members depends upon directors being obedient in this way. Boards of directors must always be attentive to the procedural requirements of the co-op to ensure that they do not act in a way that can be challenged by members or investment shareholders as unlawful.

If, for example, a co-op's constitutional documents say that membership is only open to blueberry producers in a particular county, but the board of directors accepts a membership application from someone outside that county, the board would be acting in an unlawful way. Serious breaches of the co-op's internal requirements can be brought to the courts for remedy if they cannot be resolved internally.

g. Duty to Act Within Scope of Authority

Directors need to be aware of any limitations placed on the scope of the co-op's activities. It is important to check the co-op's constitutional documents to see what the co-op's legal scope is. The co-op may have been established for quite specific purposes – for example “to market and distribute maple syrup produced by members operating in New Brunswick.” If the co-op decides to market and distribute bio-fuels produced by some of its members, the co-op may be undertaking *ultra vires* activities that are beyond the co-op's legal powers. Directors can be personally liable to the co-op or to third parties for problems arising from such unlawful activities.

If directors encounter limitations like this, the solution may be to amend the constitutional provisions to empower the proposed new activities. Changes of this nature usually require special resolutions of the members.



OTHER PRACTICAL MEASURES TO REDUCE THE RISK OF PERSONAL LIABILITY

INDEPENDENT ADVICE

Directors are not expected to be experts in all matters that come before them. But they should do their best to recognize situations that are complex and important and that require outside expertise and advice. Seeking help from a lawyer, accountant, engineer, or other appropriate professional can help a board of directors avoid or deal with problems properly. Seeking this advice is also evidence of due diligence by directors that can blunt possible claims of personal liability against the directors.

RATIFICATION OR CONFIRMATION

As noted above, conflicts of interest can, and in some cases must, be brought to the members of a co-op for consideration. Ratification and confirmation refer to membership approval after the fact. Boards of directors can seek subsequent ratification by members of other board actions as well. If ratification is obtained after full disclosure of all of the relevant facts, it amounts to an assumption of risk by the co-op itself, thereby protecting the directors from personal liability to the co-op or to individual members in relation to the act that was ratified.

INDEMNIFICATION

Indemnification is the process by which a co-op provides protection to directors in the form of reimbursement or advances for costs of defending or settling claims brought against the directors personally for actions or omissions during their service to the co-op.

It is important to be aware that the indemnification language and powers differ in the various incorporation statutes. The *Canada Cooperatives Act* states:

113. (1) A cooperative may indemnify an individual who is or was a director or officer of the cooperative, or who acts or acted at the cooperative's request as a director or officer, or an individual acting in a similar capacity, of another entity, against all costs, charges and expenses, including an amount paid to settle an action or satisfy a claim, reasonably incurred by the individual in respect of any civil, criminal, administrative, investigative or other proceeding in which the individual is involved by reason of their association with the cooperative or entity.

(2) A cooperative may advance moneys to a director, officer or other individual for the costs, charges and expenses of a proceeding referred to in subsection (1). The individual must repay the moneys if the individual did not fulfil the conditions of subsection (3), unless the members and shareholders decide, by separate resolutions, that the individual need not repay the moneys.

(3) A cooperative may not indemnify an individual under subsection (1) unless the individual

(a) acted honestly and in good faith with a view to the best interests of the cooperative, or, as the case may be, to the best interests of the entity for which the individual acted as director or officer or in a similar capacity at the cooperative's request; and

(b) in the case of a criminal or administrative proceeding, had reasonable grounds for believing that the individual's conduct was lawful.

The section goes further, and states that directors are "entitled to indemnity from the cooperative" where the directors have not committed any fault or omission and have fulfilled the conditions in subsection (3).

The Quebec *Cooperatives Act* states:

"Prosecution.

103. A cooperative shall assume the defence of its director...prosecuted by a third party for any act done or omission made in the exercise of his functions, or in the execution of a mandate on behalf of the cooperative. The cooperative shall pay any damages resulting from the act or omission, unless the director...is guilty of a gross or intentional fault.

Penal proceedings.

However, in a penal or criminal proceeding, the cooperative shall assume only the payment of the expenses of its director...if he had reasonable grounds to believe that his conduct was in conformity with the law, or the payment of the expenses of the director..., if he has been freed or acquitted, or if the proceeding has been withdrawn or dismissed."

In contrast, the *Co-operatives Act* in Newfoundland and Labrador simply gives co-ops an option to indemnify directors and officers.¹⁹

Check your incorporation statute to see what language is used to deal with indemnifications, for each statute is different. The statute may create an entitlement to indemnification, or it may simply enable co-ops to indemnify its directors. The next step is to determine whether there is a need to address indemnification into the co-op's bylaws or rules, and/or whether an indemnification agreement between the co-op and its directors is appropriate.

A potential problem with indemnification is that it can be of little or no value if the co-op is insolvent. This is where insurance comes into play. It can provide protection to co-op directors regardless of whether the co-op remains solvent.

¹⁹ See section 44 http://assembly.nl.ca/Legislation/sr/statutes/c35-1.htm#44_ (Retrieved March 12, 2008).

INSURANCE

General liability insurance provides a co-op with protection from physical injury or damage. For example, a co-op that runs a greenhouse facility may be able to insure against damage done to the facility by unusual storms. Similarly, the coverage may assist the co-op in the event that a customer slips and falls in the co-op's retail store.

Directors and Officers (D&O) liability insurance is different. It provides coverage for harm flowing from errors, omissions, misstatements, breaches of duty and other situations involving directors or officers of organizations, including co-ops.

It is important to be aware that D&O liability insurance varies from policy to policy, and there can be significant exclusions from coverage. Policies do not cover criminal, fraudulent, or dishonest actions by directors, and may exclude breaches of contract, wrongful dismissal situations, harassment, or discrimination claims. Each insurer offers different coverage, so it is essential to understand what is included and what is excluded in your co-op's D&O policy. At the end of the day, it is a matter of weighing the costs of the insurance coverage with the potential benefits of the policy to determine whether it is a prudent purchase. Carefully reviewing the co-op's insurance needs and existing coverage should be undertaken regularly. The goal is to avoid under-insuring or over-insuring.

DISSENTING VOTES

A relatively simple way for co-op directors to protect themselves from personal liability is to vote against board motions that take the co-op in the wrong direction. A director who is in the minority on a contentious issue should ensure that his or her dissenting vote is recorded in the minutes of the board meeting. In the event that a judge is later reviewing events and deciding who should be held responsible for an offense or liable for a harm, that dissenting vote will provide evidence of due diligence on that director's part.

CONCLUSIONS

The potential liabilities and duties of directors can be intimidating. But the vast majority of co-op directors serve their terms successfully without serious incidents and without great worry. Their duties can be distilled this way:

Directors of co-ops should act honestly, in good faith and the best interests of the co-op, avoid personal interests that conflict with the co-op's interests and apply their best judgment to each issue.

If directors act this way and apply the other practical measures outlined above to protect themselves, they will not need to worry about personal liability for problems at the co-op.

APPENDIX A

32 TIPS TO HELP MAKE YOU A BETTER CO-OP DIRECTOR

1. Always act honestly.
2. Always act in the best interests of the co-operative.
3. Know the co-op's articles of incorporation or other constitutional documents.
4. Study the by-laws or rules to see what governance mechanisms have been adopted, and ensure they are followed. Read the co-op's policies.
5. Become familiar with the statute under which the co-op is incorporated, and any other statutes or government regulations that are particularly relevant to the co-op.
6. Understand the co-op's business, its markets, opportunities, and challenges.
7. Learn the co-op's history.
8. Pay close attention to the state of the co-op's finances.
9. Ensure that the financial records of the co-op are clear, complete and meet bookkeeping standards acceptable to professional accountants.
10. Ensure that the co-op keeps complete and accurate non-financial records, including minutes of meetings, contracts, and correspondence.
11. Ensure all required filings are submitted to government on time.
12. If the co-op has employees, make sure all required payroll deductions are remitted on time.
13. Prepare for each board or committee meeting by studying the agenda and supporting materials.
14. Be an active director by asking questions and sharing your views and experience. Do not be afraid to ask any question.
15. Be firm if you need to be. If answers or work quality are insufficient on an important issue, say so.
16. Vote on all issues brought to the board. If the board proposes to do something you oppose, vote against it and ensure that your opposition is recorded in the minutes.
17. Declare any conflicts of interest you may have to your board colleagues (where you have a personal or family financial interest in an issue also of interest to the co-op). If you are in a conflict, do not participate in the discussions or vote on the issue in question. Ensure the minutes reflect the facts that you disclosed the conflict and did not participate further.

18. Be transparent in your relations with board colleagues and co-op members.
19. Keep your own written notes of board and committee meetings.
20. Review the minutes to ensure they are complete and accurate.
21. Follow up on decisions and commitments.
22. Establish and monitor internal risk management policies and practices.
23. Manage risks by considering the facts, risks, and options and applying your best judgment.
24. Obtain independent professional advice (legal, accounting, etc.) on difficult and important issues.
25. If you plan to issue investment shares, consult a securities lawyer.
26. Assess the insurance needs of the co-op on a regular basis. Avoid under-insuring and over-insuring.
27. Pay attention to changing circumstances internally and externally.
28. Engage in regular planning and performance review.
29. Adopt and refine a governance model and practices and organizational structures suited to your co-op.
30. Encourage young people to become co-op directors.
31. Understand and apply the co-operative principles.
32. Don't rely completely on this list. It doesn't cover all situations.

APPENDIX B

LINKS TO CO-OP LEGISLATION

Canada Cooperatives Act

<http://laws.justice.gc.ca/en/showdoc/cs/C-1.7///en?page=1> (Retrieved March 12, 2008)

Alberta Cooperatives Act

http://www.qp.gov.ab.ca/documents/Acts/C28P1.cfm?frm_isbn=077975283X (Retrieved March 12, 2008)

British Columbia Cooperative Association Act

http://www.qp.gov.bc.ca/statreg/stat/C/99028_01.htm (Retrieved March 12, 2008)

Nova Scotia Co-operative Associations Act

<http://www.gov.ns.ca/legislature/legc/statutes/coopassc.htm> (Retrieved March 12, 2008)

Manitoba The Cooperatives Act

<http://web2.gov.mb.ca/laws/statutes/ccsm/c223e.php> (Retrieved March 12, 2008)

New Brunswick Co-operative Associations Act

<http://www.gnb.ca/0062/acts/acts/c-22-1.htm> (Retrieved March 12, 2008)

Ontario Co-operative Corporations Act

<http://www.canlii.org/on/laws/sta/c-35/20080215/whole.html> (Retrieved March 12, 2008)

Quebec Cooperatives Act

<http://www.canlii.org/qc/laws/sta/c-67.2/20080215/whole.html> (Retrieved March 12, 2008)

Newfoundland and Labrador Co-operatives Act

<http://assembly.nl.ca/Legislation/sr/statutes/c35-1.htm> (Retrieved March 12, 2008)

Prince Edward Island Co-operative Associations Act

<http://www.gov.pe.ca/law/statutes/pdf/c-23.pdf> (Retrieved March 12, 2008)

Saskatchewan, The Co-operatives Act, 1996

<http://www.qp.gov.sk.ca/documents/English/Statutes/Statutes/C37-3.pdf> (Retrieved March 12, 2008)

Yukon Cooperative Associations Act

<http://www.gov.yk.ca/legislation/acts/coas.pdf> (Retrieved March 12, 2008)

Northwest Territories Co-operative Associations Act

http://www.justice.gov.nt.ca/PDF/ACTS/Co-Op_Assoc.pdf (Retrieved March 12, 2008)

Nunavut Co-operative Associations Act (Nunavut)

http://action.attavik.ca/home/justice-gn/attach-en_conlaw_prediv/Type0371.pdf (Retrieved March 12, 2008)