

# Director Duties- Keeping a Reserve

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This article is the first of a two part series on maintaining reserves for not-for-profit organizations and charities. This one deals with reserves and the duties of directors, while the second part will provide tips on how to develop a reserves policy. When the economic climate is weak, it may be tempting for organizations to dip into their reserve or contingency fund, if they have one, or to stop contributing to it on the basis that available money should be used to promote the organization's programs and activities. However, directors should proceed with care to ensure that by doing so, they are not jeopardizing the financial sustainability of the organization or breaching their fiduciary duties owed to the corporation.

A key function of the board as it exercises its duty to govern the activities and affairs of the organization is to ensure the financial wellbeing and sustainability of the corporation. Financial stewardship merits particular attention because individual directors can incur personal financial liabilities for failure to exercise due diligence in that regard. In addition, failure to carry out those responsibilities can give rise to unfunded or contingent liabilities, which carry with them the risk of insolvency and ultimate dissolution of the corporation. One of the most common reasons for the existence of unfunded liabilities is the failure to set aside or maintain adequate reserves to deal with long-term commitments and the costs of contingent liabilities. Unfunded liabilities may also arise when the operating costs and contractual obligations to staff, members, suppliers or other third parties exceed the organization's ability to generate revenue. For those reasons, directors are strongly encouraged and will want to ensure that the organization maintains an adequate surplus, reserve or contingency fund.

Directors should be mindful though that the Canada Revenue Agency (CRA) has rules in respect of how not-for-profit organizations and registered charities may maintain reserves. The CRA has stated that in order to maintain tax-exempt status, not-for-profit organizations must ensure that such reserves are "reasonable" and for an identifiable operating purpose or a specific, future capital project. While the CRA acknowledges that registered charities can, and in some circumstances should, maintain a reserve fund, fundraising that results in an unjustified level of reserves may cause the CRA to question whether the charity is meeting the requirement to devote its resources exclusively to charitable activities. Accordingly, directors should ensure that the level of reserves maintained is justified and reasonable so as to avoid compromising the organization's non-profit or charitable status.

Corporations are separate legal entities from their directors and members and therefore, directors and members are generally not liable for corporate obligations. However, there are some exceptions to this principle of limited liability for which directors can be held personally liable, particularly if the corporation suffers a financial loss that can be directly attributed to

their actions or omissions. Of notable relevance are the statutory liabilities imposed on directors personally for unpaid wages, which typically arise where the corporation is insolvent. For example, the *Canada Not-for-profit Corporations Act* (“CNCA”) provides directors may be held jointly and severally, or solidarily, liable to employees for up to six months’ wages for services performed for the corporation while they are directors. Similar statutory liabilities exist for amounts the corporation has failed to deduct, withhold, remit or pay under the *Income Tax Act*, the *Excise Tax Act*, Canada Pension Plan and other employment-related legislation.

Some statutes, such as the CNCA, the *Income Tax Act* and the *Excise Tax Act* prescribe a due diligence defence for directors through which directors can be protected from personal liability for unpaid wages or for a failure to comply with statutory requirements. Directors can avail themselves of this defence if they exercised the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances. However, this defence might be of little assistance to directors who failed to properly carry out their financial oversight role. For example, directors who are more focused on carrying out the work of the organization than on governance and financial oversight may gradually deplete the financial reserves of the organization. Recurrent spending without regard to the availability of adequate resources and long-term financial health of the organization will be difficult to defend if such decisions render the corporation insolvent or result in significant unfunded liabilities that cannot be satisfied by the corporation upon its winding-up or dissolution.

Part II: Tips on developing a reserves policy.