Charity Law and Practice Review

A NEW CHARITABLE INCORPORATED VEHICLE

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This article considers proposals in Chapter 9 of the DTI consultation document "Modern Company Law For a Competitive Economy - Developing the Framework" for the creation, in fresh legislation, of a new, incorporated legal form for use by charities. This exciting, reforming, concept has actually been around in embryo for several years, having first been put forward by a combination of the Charity Law Association, the NCVO and the Charities Unit at Liverpool University. It is not without its controversial aspects, but it is most encouraging to those who were involved directly or indirectly at the outset to find that the Government is prepared to take the matter seriously. The current proposals are driven more by the economic demands of modern company law, however, than by the needs of charities as such, and it will therefore be important for the charity sector to make its views known very clearly at all stages if the interests of charities, rather than just the efficient regulation of companies, are to be properly served.

Prizes could be offered for a better name for the new entity, which is currently referred to as a 'charitable incorporated institution' or CII. The proposals are contained in Chapter 9 of the massive consultation document, and skeleton instructions to Parliamentary Counsel available only from the DTI website.

Background to the Proposals

The main theoretical basis for the proposals is that company law, and in particular the form of the company limited by guarantee, are not entirely suited to the needs of charities. They have been adapted from a commercial model which comes from a very different tradition from the voluntary sector's, and does not operate smoothly alongside the trust concept. Companies also depend on external regulation with a different ethos and different priorities from those of the Charity

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Commission, by which most charities (including virtually all charitable companies) are regulated.

The use of the unincorporated association, whilst superficially attractive to those who wish to establish charities without legal advice or who do not have the experience, will or expertise to administer a company efficiently, is not generally regarded by charity lawyers (or accountants) as in any way an adequate alternative. The basic legal rules relating to unincorporated associations are in many respects uncertain (the only serious textbook on the subject being Jean Warburton's slim volume), and again the special principles applying to charitable associations make them even more difficult to identify or explain.

In practical terms, the awkward relationship between the conflicting legal environments for companies and associations on the one hand and charity law on the other can all too easily lead to muddle. This is unacceptable in a sector which is growing fast, not only in relation to the number of charities but also in relation to their size and significance and the scope of their activities, and for which financial wrongdoing or mismanagement is peculiarly damaging. By the same token, the perceived need for charity trustees to have the protection of limited liability has never been greater.

Indeed it is interesting to recall that when the Charities Bill which became the Charities Act 1992 was before the Select Committee of the House of Lords in late 1991, an amendment was put forward to confer limited liability on the charity trustees of unincorporated charities provided that they complied with their legal duties. Their liability was to be limited to the value of the charity's assets. The amendment gained very considerable support from charities and their umbrella bodies, but was eventually withdrawn when Ministers reported to the House that it would go against fundamental principles of trust law.

Research was undertaken at Liverpool University in the mid 1990s into alternative forms of legal structure in use by charities in Australia, New Zealand, France and Germany. A survey, in which a cross-section of 1,500 charities were invited to take part, elicited common concerns about trustee liability, conflicts of interest, the constraints imposed by a large membership, limited borrowing powers and other constitutional problems. Most respondents wanted a legal structure with limited liability, wide powers and sufficient safeguards. The result of the project was a report (produced in September 1997 by a working party composed of members of the Charity Law Association and NCVO as well as the University). The report made specific proposals for a new legal structure and appended a skeleton bill. Initially this was submitted to the Charity Commission, but through the mysterious workings of inter-departmental communications

emerged in somewhat different form as a minor part of the present consultation document on the reform of company law.

The CLA Working Party

The Charity Law Association has set up a fresh working party to consider and respond to the DTI proposals, and the remainder of this article is based on their draft response.

The DTI posed four specific questions on which it sought views. These were as follows:

1 Do you agree that there should be a separate form of incorporation for charities?

2 Do you agree that the new form of incorporation should be restricted to charities? If not, how would you draw up eligibility?

3 Should bodies eligible for incorporation as a CII be prevented from incorporating under the Companies Act?

4 Should companies presently registered under the Companies Act be required to re-register under the new regime if they are eligible?

The working party answers "Yes" to the first two questions and "No" to the last two.

On the first question, it is convinced that the needs of charities for a suitable range of legal forms would be better met if there were another form of incorporated body designed specifically for charities.

At present, many charities are incorporated as companies limited by guarantee; a few as companies limited by shares; a few as unlimited companies; some, exceptionally, by Royal Charter or Act of Parliament and many as societies registered under the Industrial and Provident Societies Acts (IPSs). Some charities enjoy the benefits of incorporation indirectly through the incorporation of their trustee bodies, whether as companies (or other corporate bodies) or by certificate of the Charity Commission under s.50 of the Charities Act 1993. Except for the last, which does not confer limited liability,[2] none of these forms is available exclusively to charities.

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2 See s.54. It is an interesting question in itself to determine precisely what it means.

All the available forms have their advantages and disadvantages. What is missing at present, as the research has shown, is a form of incorporated charity with limited liability for its trustees which is simple and inexpensive to administer and subject to the supervisory jurisdiction only of the Charity Commission (and the court).

In the working party's view the form of a charitable company limited by guarantee, which otherwise comes the closest to filling the gap, is less than satisfactory for the following reasons:

(1) it is structurally more complex than strictly necessary for many charities;

(2) it requires a degree of sophistication to administer;

(3) it is particularly over-elaborate for grant-making bodies;

(4) it necessitates compliance with company law, which is based on a commercial model, especially in relation to reporting and accounting issues;

(5) it also involves compliance with charity law, which is based on a trusts model, and the oversight of the Charity Commission.

The working party are also conscious that the development of company law, including many of the developments envisaged in the Consultation Document, and many of the changes inspired by European Community law, has perforce to proceed without much regard to the needs and requirements of charitable companies, which are very much a minority and have only a limited role in economic life.

There are, of course, significant attractions in the idea that a new form of structure might be available for use by other not-for-profit bodies, many of which are similar in many ways to charities. To some extent, that problem might be better addressed by reviewing the scope of charity itself, as the Commission are already doing through the Review of the Register. The working party have three main reasons, however, for their view that the new structure should be available for charities only.

(1) Charities themselves cover a wide range of organisations, and they feel that it would be difficult enough to devise a straightforward, easily administered form which can be used by a wide range of charities without

adding the additional and harder task of adapting it for other, non-charitable bodies. Charities should have priority.

(2) The intention is to devise a form which suits charities better than the company limited by guarantee. If the new form is ideally suited to charities, it will not be so suitable for non-charitable bodies; whereas if it is suitable for a wider range of organisations, it may be less than ideally suited to charities. To take into the wide-ranging requirements of other not-for-profit bodies would dilute the focus on the requirements of charities.

(3) Simplicity is the key to the proposals. The working party have been convinced by the DTI's arguments that the Charity Commission should be the registration authority, and that registration should have the effect both of incorporating a CII and giving it legal recognition as a charity. They frankly do not see that any more suitable body could be identified or designed for the purpose. They can also see that it would not be possible for the Charity Commission to act as registrar for non-charitable bodies without a change in its constitution, which might be controversial; whereas, if a body other than the Charity Commission were the registrar, there would be a strong argument to the effect that CIIs (like IPSs) should be exempt charities. If the Commission is to take on the new role, however, the Government must not be under any illusion that this is a cheap solution: it must be given adequate resources to do the job properly.

There are persuasive arguments to the effect that the new structure should be a compulsory replacement for the charitable company, at least in relation to new charities, and these arguments have found favour with some mainstream company lawyers, who wish to see charitable companies removed from the regulatory regime for companies. The working party, however, cannot agree that new charities should be prevented from seeking incorporation as companies, for the following reasons.

(1) The CII will be a completely new form of a legal entity. Charities operate in the real world and need a degree of credibility when borrowing money or leasing buildings. It may take some time for the confidence in the new form to develop in the commercial world, and charities would be at a disadvantage compared with non-charitable bodies if they were limited to that form before it was generally known and accepted.

(2) For the same reason, there may well be initial practical or administrative difficulties in operating the form which might make it prudent for some

types of charity, especially those operating institutions on which substantial numbers of people depend, to delay conversion at least until some experience of it had been gained. In some cases it might prove desirable to operate two forms side by side for a time.

(3) The CII should be designed as a fairly simple form of organisation. It may not be in the interests of some charities (especially those which have numerous subsidiary charities and subsidiary trading or operating companies) to convert. Even if they decide to convert, it may take some time for them to consider and decide upon the best way of restructuring. It is far more important that the charitable work that charities are carrying out should continue to be carried out effectively and efficiently than that a particular legal form should or should not be adopted.

(4) It would be contrary to the ethos of the voluntary sector, and of charities in particular, to introduce such an element of compulsion into the internal organisation of charities. There would also be the risk of excessive power being concentrated in the hands of the Charity Commission, whose governing statute currently precludes them from interfering in the administration of a charity.

(5) If the CII is a success, charity trustees will choose voluntarily to convert to it whenever it is in the best interests of the charity to do so.

As a result, the working party consider that existing charitable companies should *not* be compelled to re-register as CIIs.

On the other hand, bearing in mind that registration of a CII will perform a dual purpose - incorporation and recognition - they wish to recommend that there should be a simplified procedure whereby a charitable company (or a charity of any other kind which has been registered with the Charity Commission) can convert to a CII. It would save time and staff costs for the Charity Commission as well as saving time and legal costs for the charity itself if a simplified procedure were available whenever an existing registered charity changes its form but not its objects on incorporation, whether as a charitable company or otherwise, even though technically a new body is created.

The Skeleton Instructions

The skeleton instructions to Parliamentary Counsel appear to be based very closely on company law and thereby to defeat one of the main objects of the

whole proposal, so far at least as the Charity Law Association is concerned, to design a form specifically for charities and not having the company law baggage which currently makes the charitable company less than ideal for charities' use. They strongly recommended that the language and concepts used in the new legislation should be taken from the charity sector rather than company law or practice, even though the legislation might eventually see the light of day as part of a Companies Bill rather than a separate piece of legislation for CIIs. Even charitable companies, for example, nowadays refer to 'trustees' rather than 'directors', and it will be highly desirable to avoid the problem which currently tends to confuse the trustees of many charitable companies and their professional advisers, by making it clear that the duties of CII trustees towards the charity are the same as the duties of all other charity trustees.

There is a somewhat metaphysical question whether the harmonising of the duties of trustees of CIIs with those of the trustees of unincorporated charities would necessitate an express provision to the effect that all funds belonging to a CII were technically held on trust rather than beneficially. It essentially comes down to a question of drafting, and of how thorough the reform is to be. Ideally, serious consideration ought to be given to the statutory harmonisation of the fundamental duties of *all* charity trustees, be they trustees of a trust, members of the committee of a charitable unincorporated association or charitable IPS, council members of a charter corporation, directors of a charitable company or members of the governing body of a CII. For practical purposes, however, the working party feel that - provided that the liability of the trustees would be limited - it would be acceptable for CIIs to hold their assets on trust.

The skeleton instructions, using the company model, assumed that CIIs would have members as well as trustees. There is of course no necessity for all CIIs to have members. In some cases it would be preferable for the trustees to be the only persons involved in the structure, e.g. where the CII replaces a classic form of charitable trust. In other cases a membership will be desirable, as a source of fund-raisers and trustees, and possibly as a form of democratic influence where this is appropriate. But the powers of the members need not be nearly as extensive as is appropriate for the shareholders of a commercial company (the beneficial owners).

The working party endorses the original, joint working party's recommendation that the legislation should recognise two forms of CII, a Foundation and an Association, both of which are concepts familiar in EU community law. They will refer for comparison to the form of incorporated association in Australia and the statutory forms of higher education corporations and further education colleges provided for under the Education Reform Act 1988 and the Higher and Further Education Act 1993. Some of the provisions of the Charities Act 1993

Part VI, relating to the incorporation of trustee bodies, could be useful precedents for the vesting in and transfer of property to CIIs on incorporation.

The skeleton instructions suggested that registration of a CII should be evidence of 'compliance with the conditions of registration'. The working party strongly disagree. It considers that if the CII is a charity, charity law should apply in its full rigour because of its charitable status, not because it has been registered. If a CII in fact does not apply its funds correctly, that should be a reason for refusal of tax relief (and other consequences) as with any other charity.

The cancellation of the registration of a CII will obviously be a very powerful sanction, because not only will it remove the presumption of charitable status but it will also, more drastically, destroy the corporate body itself and thus cause the charity to cease to exist. The working party therefore consider that great care should be taken to prevent the risk of abuse (even inadvertent abuse) of this sanction. There is a Human Rights aspect to this, since although the right to life does not apply to an artificial person, the protection of property enshrined in the First Protocol does, and a consequence of cancelling a CII's registration will be that its property will be at the disposal (probably by means of a scheme) of the Charity Commission.

The working party particularly wish to recommend that cancellation of registration should not be available in circumstances when it is not currently available in relation to other charities, especially not as a penalty for non-compliance with reporting obligations, as the skeleton instructions proposal. The working party regard that as a draconian measure which would be out of keeping with the standards of reporting hitherto applied by the Charity Commission, and one which would have very serious resource implications for the Commission if the system were to be operated efficiently and fairly across the range of non-exempt charities.

The same applied to the suggestion that registration should be capable of cancellation on grounds of misconduct or mismanagement, a sanction which, again, is inapplicable to other charities and could operate harshly and/or unfairly.

The working party consider that the Commission's existing powers of dealing with failure to report and other forms of mismanagement or misconduct are adequate to deal with CIIs, and the increasingly sophisticated system of monitoring which the Commission is developing should be adequate to identify cases where remedial action on their part is necessary. The one area in which they do suggest that an additional sanction specifically for CIIs should be provided is in relation to limited liability. The most effective and least costly step

which could be provided for, in their view, would be the removal from the trustee body, or specified members of it, of the benefits of limited liability. Since limited liability is likely to be one of the main reasons for choosing the form of a CII, the threat of its removal is also likely to provide an effective incentive to comply with the obligations attached to trusteeship of a CII. Removal of the benefits of limited liability could be carried out by an Order of the Charity Commission similar to an Order suspending trustees after a s.8 inquiry, either on notice or, at the option of the Commission, without notice.

They also wish to recommend that, in line with deregulation in other areas, small CIIs should be subject to less stringent reporting and other requirements than the norm. If such a concession is not granted, there will be less incentive to choose the form of a CII instead of (for example) an unincorporated association. On the other hand they are not convinced of the need for trustees of CIIs to be able to remain anonymous, as the skeleton instructions propose. There will always be special cases where charity trustees need to remain anonymous for their own protection, but this applies generally across the range of charities and is not a constitutional issue.

The skeleton instructions also suggest that the name and address of a CII should artificially be treated as part of its 'trusts' and therefore available to the public. The working party think that it would be useful for the Commission to be required to make such details available to enquirers for all types of registered charities, not just CIIs.

The skeleton instructions contain some indication that members of a CII should be in a special position comparable with the shareholders of a company limited by shares. The legal basis for the rights of the members of charities is a highly uncertain area, which appears partly a matter of trust (see *Brooks v Richardson)*[3] and partly a matter of contract, but may also have public law features, at least where the charity has overtly public functions. The working party doubted whether the proposed legislation would be the right place to tackle the problem, since to consider the ramifications thoroughly would risk lengthening the whole process. They are inclined to the view that it would be best to leave the Commission to deal with membership issues in the context of claims of maladministration, as they already do in relation to existing membership charities, rather than conferring on them a special power to adjudicate between members and trustees (as the skeleton instructions envisage), which would be an extension of their functions.

2 [1986] 1 WLR 385.

The original working party's idea was that the powers and duties of the trustees of CIIs should be set out comprehensively in the legislation. The introduction of the Trustee Bill has altered the position in that it gives rise to an excellent opportunity to clarify many unwritten rules and apply them not only to trustees as such but also, *mutatis mutandis*, to charity trustees as a class. The same applies to regulations about the remuneration of charity trustees which it is proposed should be made under the new Act.

It is not clear from the skeleton instructions whether it is envisaged that the Commission would have the same powers in relation to CIIs as they have in relation to other charities (e.g. to advise, investigate and if necessary, following an investigation to take protective or remedial action) or whether it is envisaged that they would have a more 'hands-on' role in relation to CIIs. The working party strongly feel that the Commission's existing powers, with the addition of the power to remove the benefit of limited liability, will be more than adequate.

It seems clear that any property representing permanent endowment of a CII, like any property held for special purposes with or connected with the objects of the CII, should be held on trust. This is not specifically dealt with in the DTI's proposals and needs to be clarified, as does the more general question whether a CII's general purpose property is to be held beneficially or on trust. Trust property on a winding up will have to be applied under a scheme unless there is an outlet for the funds in the trusts themselves.

There is an indication in the skeleton instructions (though not in the main text of the proposals) that only existing incorporated charities should be able to convert to CIIs. This addresses only part of the existing problem. All kinds of registered charities should be able, if their trustees so wish, to convert very easily to the form of a CII. Apart from charitable companies, there are many unincorporated charitable associations whose activities would benefit greatly from a more structured constitution, and more certainty about the powers and duties of their trustees and members, and there is no reason why the form should not also be readily available to charitable trusts seeking the administrative advantages of incorporation as an alternative to seeking the incorporation of their trustee body under s. 50 of the Charities Act.

The skeleton instructions propose that the Charity Commission should have a power, based on company law rules, to relieve CII trustees from liability for breach of duty. Whilst it is right that the court should be able to relieve the trustees of a CII from liability for a breach of trust as under s.61 of the Trustee Act 1925, it is not helpful for the provision to be directly derived from company law, since this is an area of confusion which should be avoided. Further, to