THE LAW COMMISSION'S CHARITY LAW PROJECT

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Introduction

The Law Commission for England and Wales was created by Parliament to keep the law under review and to recommend reform where it is needed. The Commission celebrates its 50th anniversary next year and, since its creation in 1965, numerous Acts have been passed implementing its recommendations.[1]

Over the last decade, charity law has been on the agenda of both Parliament and the Law Commission. The Charities Act 2006 heralded various reforms, most notably (and controversially) the removal of any presumption of public benefit in relation to certain types of charity.[2] Then the Perpetuities and Accumulations Act 2009 implemented Law Commission recommendations from 1998; amongst other

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1 A full list of our published reports is available at: http://lawcommission.justice.gov.uk/publications/publications-by-ref-number.htm and a summary of the implementation of our reports is available at: http://lawcommission.justice.gov.uk/docs/implementation_log_311013.pdf

2 Whether such a presumption previously existed is a matter of some debate, summarised in H Picarda, *The Law and Practice Relating to Charities* (4th edn, Bloomsbury Professional, 2010) 36-39F. In *R (Independent Schools Council) v Charity Commission for England and Wales* [2011] UKUT 421 (TCC), [2012] Ch 214, 88 the Upper Tribunal said that the 2006 Act had made 'little, if any, difference to the legal position of the independent schools sector'. As well as addressing the public benefit requirement, the 2006 Act, amongst other things, created the Charity Tribunal (whose functions have now been subsumed within the First-tier Tribunal (General Regulatory Chamber)), created the charitable incorporated organisation, and amended the registration thresholds for charities.

things it reformed the accumulation period for charitable trusts.[3] The Charities Act 2011 was a consolidation measure drafted by the Law Commission.[4] Finally, the Trusts (Capital and Income) Act 2013 implemented the Law Commission's recommendations by simplifying the procedure by which permanently endowed charities can invest their endowment on a total return basis.[5]

The Law Commission's work on charity law has not stopped there. In March 2013 we commenced a project on selected issues in charity law, which we expect to complete in 2016. The project has been in development for some time. In July 2011 we announced that we would be undertaking a review of charity law as part of our Eleventh Programme of Law Reform,[6] but at that time only part of the terms of reference had been settled - an examination of the procedures by which charities incorporated by royal charter and by statute amend their governing documents. The remainder of the project would comprise issues arising from Lord Hodgson's review of the Charities Act 2006; we had in mind that the review might identify various legal problems faced by charities which were suitable for review by the Law Commission.

Lord Hodgson's report, *Trusted and Independent: Giving charity back to charities - review of the Charities Act 2006* ('the Hodgson Report'), was published in July 2012.[7] Of his 103 recommendations, some were accepted by Government, some were rejected, and others were referred to the Law Commission for further

3 Law Commission, *The Rules Against Perpetuities and Excessive Accumulations* (Law Com No 251, 1998).

4 It consolidated numerous statutory provisions, most notably the Recreational Charities Act 1958, the Charities Act 1992, the Charities Act 1993, the Charities (Amendment) Act 1995, and the Charities Act 2006.

5 Law Commission, *Capital and Income in Trusts: Classification and Apportionment* (Law Com No 315, 2009).

6 Law Commission, *Eleventh Programme of Law Reform* (Law Com No 330, 2011) available at http://lawcommission.justice.gov.uk/docs/lc330_eleventh_programme.pdf

7 Lord Hodgson of Astley Abbotts, *Trusted and Independent: Giving charity back to charities - review of the Charities Act 2006* (July 2012) available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/79275/Charities-Act-Review-2006-report-Hodgson.pdf

consideration.[8] What emerged was a project comprising several discrete, technical legal issues relating to such matters as the regulatory framework for certain charity transactions and dispositions, the powers of the Charity Commission and the Charity Tribunal, charity insolvency, and charity mergers.[9] In line with the general approach of the Law Commission and consistent with its independent status, we are not addressing matters of political controversy; in particular we are not consulting upon anything that would change the definition of a charity.

The issue that we considered first, and with which this article is primarily concerned, is the law relating to social investment by charities. Social investment is the use of funds to achieve both a financial return and a social good. For example, some people invest in local credit unions, or buy shares in windfarms, because they want to support the work that the organisation is doing. That might involve either getting a lower rate of financial return than would be available from a mainstream investment, or accepting reduced liquidity. The motivation for making a social investment may be primarily financial, or primarily related to the social good, or a balance of both - and so may the return from the investment.

In his report, Lord Hodgson said:[10]

> charity law (along with general trust law and prevailing accounting and financial regulation), while not actively prohibiting social investment, is certainly not set up to support it. There is no clear legal basis for investments of this type, causing nervousness among trustees and their advisors. … In this situation, social investment will always be the difficult option, discouraging those with a flicker of interest from pursuing the project further and presenting serious barriers to even the highly committed.
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> Social investment, then, should become far better integrated into the overall legal and regulatory framework. Reforms to charity law are a good place to start. … What is needed is a more permissive legal

8 See Cabinet Office, *Government Responses to (1) The Public Administration Select Committee's Third Report of 2013-14: The role of the Charity Commission and 'public benefit': Post-legislative scrutiny of the Charities Act 2006, and (2) Lord Hodgson's statutory review of the Charities Act 2006: Trusted and Independent, Giving charity back to charities* (September 2013) Cm 8700 available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/237077/Response-charities-legal-framework.pdf

9 The terms of reference for our project are available at: http://lawcommission.justice.gov.uk/docs/charity_law_terms-of-reference_updated.pdf

10 The Hodgson Report (n 7) paras 9.21, 9.22 and 9.24.

> environment, where trustees are confident of their ability to take the action they consider to be in the best interests of their charity …

In response, the Law Commission was asked by Government to consider whether anything could be done by way of law reform to make clearer the powers and duties of charity trustees in undertaking social investment. We were also asked to review the law relating to the social investment of non-functional permanent endowment.

In April 2014 we published a consultation paper on social investment by charities.[11] After analysing the responses to the consultation, we formulated our final recommendations for reform, which we published in September 2014.[12]

This article explores our final recommendations concerning social investment by charities. It then summarises the remaining issues that we will be considering in the next phase of our project.

Social Investment by Charities

As explained above, a social investment is any use of funds from which the investor seeks both a financial return and a social good. Social investment is not an activity that is unique to charities; any private investor, company or pension trust might make a social investment. But since every social investment is driven, to some extent, by the social good it is expected to achieve, it is pertinent for charities. It can give charities the opportunity to use their funds both to advance their charitable purposes and also to obtain a financial return. The financial return can then be used to fund future charitable activities.

Many social investments will be expected both to preserve the capital invested and to provide an additional return, in the form of income or capital growth (or both). We refer to this as a 'positive financial return'. But some social investments (such as interest-free loans) will be expected only to maintain their initial capital value, and others will be expected to produce only partial repayment of the initial investment, which we refer to as a 'negative financial return'. Some social

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11 Law Commission, *Social Investment by Charities* (Law Com CP No 216, 2014), hereafter 'the Consultation Paper' available at: http://lawcommission.justice.gov.uk/docs/cp216_charities_social_investment.pdf

12 Social Investment by Charities: The Law Commission's Recommendations (2014) available at: http://lawcommission.justice.gov.uk/docs/cp216_charities_social_investment_recommendations.pdf

investments will carry such a high degree of volatility that charity trustees cannot reliably measure their expected financial return.

Charities have been making social investments for many years. For example, the Sir Thomas White loan charity, which provides interest-free loans to young businesses, was founded in 1542.[13] The loans provided by the charity are social investments since they pursue the charity's purpose of relieving poverty whilst also generating a financial return for the charity in the form of the repayment of the loan. Similarly, homelessness charities that purchase and let out properties to homeless people at a low rent are long-standing social investors, as are charities for the relief of poverty that invest in overseas development projects.

In addition to these historic activities, new forms of social investment have emerged in recent years.[14] Social investors, including charities, have pooled their assets to invest on a collective basis in funds which aim to deliver social benefits as well as financial returns.[15] And the UK's first social impact bond (under which investors' financial returns increase with the success of the social project being funded) was created in 2010 to fund a project aimed at reducing recidivism amongst individuals leaving HM Prison Peterborough. Charities invested in this bond and in subsequent social impact bonds.[16]

The social investment market is growing. It has been suggested that its value in 2011/2012 was over £200 million and that this value could increase to £1 billion by 2016.[17] Charities, as investors, may derive significant benefits from this emerging and growing market. Equally, however, charities may not wish to make social investments at all, and our recommendations do not in any way seek to impose social investment on charities.

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13 See www.stwcharity.co.uk. We are grateful to Francesca Quint for bringing this charity to our attention.

14 We set out various examples of social investment in Consultation Paper (n 11) ch 2.

15 In the Consultation Paper (n 11) we referred to two examples: the Bridges Social Entrepreneurs Fund created in 2009, and the Big Issue Invest Social Enterprise Investment Fund created in 2010.

16 In April 2014, the Ministry of Justice announced that the funding structure of the Peterborough social impact bond would change for the third and final cohort of prisoners involved in the pilot as a result of wider reforms to the probation service: see https://www.gov.uk/government/news/payment-by-results-prison-pilot-continues-to-show-falls-in-reoffending

17 We analyse these figures in more detail in the Consultation Paper (n 11) para 1.30.

Legislation relating to social investment

The English and Welsh statute book is silent on social investment.[18] It has, however, featured in US tax legislation for some 45 years. The US Tax Reform Act 1969 introduced into the Internal Revenue Code the concept of 'program-related investment'.[19] Charitable private foundations in the US are afforded tax exemptions.[20] But those private foundations nevertheless face tax penalties if they make investments that 'jeopardize' the carrying out of the foundation's charitable aims.[21] An investment is 'jeopardizing' if 'the foundation managers, in making such an investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long and short-term financial needs of the foundation to carry out its exempt purposes'.[22] An exception exists for 'program-related investments', which are deemed not to be 'jeopardizing'.[23] An investment will be a 'program-related investment' if its 'primary purpose … is to accomplish one or more of the [exempt] purposes' and 'no significant purpose … is the production of income or the appreciation of property'.[24] Without the exception, a 'program-related investment' might be 'jeopardizing' if it is high risk or if it is an investment that would not be made by an investor investing solely for profit.

In the US, the recognition of 'program-related investments' is also particularly important for 'non-operating' charitable private foundations.[25] Such foundations face a tax penalty unless they distribute 5 per cent of the value of the foundation's assets each year.[26] But funds used for 'program-related investments' count

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18 Although social investment is perhaps anticipated by legislation; restrictions on the disposal of charity land in Charities Act 2011, ss 117-121 do not apply to the grant by a charity of a lease at below-market rent to enable a beneficiary of the charity to occupy the property for the charity's purposes. Such a transaction would be a social investment.

19 Internal Revenue Code ('IRC'), § 4944. See, generally, R Pozen, 'A guide to charitable investing' (2012) 18(3) Trusts & Trustees 185.

20 ibid, § 4940(a). The word 'charitable' is used here as shorthand for the various purposes specified in § 501 which afford tax exemption, not all of which would be charitable in England and Wales.

21 ibid.

22 Code of Federal Regulations, title 26, § 53.4944-1, (a)(2)(i).

23 IRC, § 4944(c).

24 ibid. Those bare bones of a definition are given more flesh by the Code of Federal Regulations, title 26, § 53.4944-3.

25 The detailed definition of an 'operating foundation' is set out in IRC, § 4942(j)(3).

26 ibid, § 4942(a).

towards that 5 per cent distribution requirement.[27] Given that a 'program-related investment' might yield a financial return, it can be an attractive option for private foundations seeking to satisfy the 5 per cent distribution requirement as the foundation is not required to divest itself completely of its assets, as it would if it were making a grant.

The social investment spectrum

Whilst legislation in England and Wales makes no mention of social investment, it is referred to in guidance issued by the regulator of charities, the Charity Commission for England and Wales. The Charity Commission published guidance on the investment of charitable funds in 2003, which referred to 'programme-related or social investment', adopting the term that had been used in the US legislation and which had found its way into charity sector parlance. The Charity Commission published revised guidance on the investment of charitable funds in October 2011, known as 'CC14'.[28] CC14 refers to programme-related investment ('PRI') but also introduced a new term, 'mixed-motive investment' ('MMI').

The Charity Commission explains that PRI:[29]

> allows a charity to directly further its aims and, at the same time, potentially achieve a financial return. In making a PRI, trustees are not bound by the legal framework for financial investments ..., because their decision is about applying assets directly in furtherance of the charity's aims.

It then explains that MMIs are investments that cannot be entirely justified as a financial investment or as a PRI, but have elements of both and are in the charity's best interests based on 'the dual nature of the return'.[30]

Social investments by charities can be seen as a spectrum. When making any social investment, charity trustees will always have in mind - to differing extents - the direct furtherance of their charity's purposes and the generation of a financial return. The same social investment may be classified as a PRI by one charity, an

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27 ibid, § 4942(g).

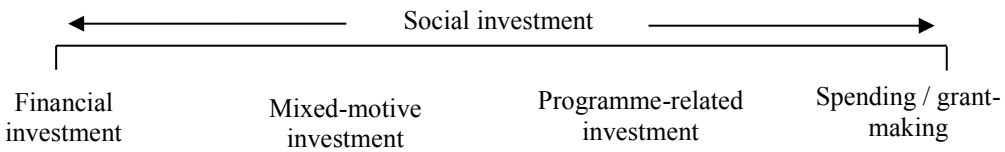
28 Charity Commission, *Charities and Investment Matters: A guide for trustees* (CC14) (October 2011) available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/302278/cc14text.pdf

29 ibid, 36.

30 ibid, 48.

MMI by another and a purely financial investment by another. This will depend on the breadth of the charity's objects and on the charity trustees' intentions in making the social investment.[31] We see the spectrum as depicted in Figure 1. There are no clear dividing lines along that spectrum; the PRI and MMI classifications have no significance in law and they are potentially unhelpful due to their lack of precision.

Figure 1: spectrum showing the range of possible applications of charitable funds



Legal barriers to social investment by charities

Lord Hodgson suggested that the legal landscape was not set up to support social investment. We agree. As noted above, legislation is silent on social investment. Moreover, there is a dearth of case law relating to social investment. Thus far it has been necessary to ascertain principles from other cases and apply them by analogy to social investment. That leaves much room for argument amongst lawyers, and consequential caution on the part of charity trustees.

The Law Commission's review of the law led it to identify four potential legal barriers to charities making social investments.[32] First, there is some lack of clarity as to whether charity trustees have the power to make social investments. Second, charity trustees need to know the duties to which they are subject when making social investments. Third, they also need to know the extent to which permanent endowment can be used to make social investments. Fourth, the law relating to private benefit may be a barrier if it prevents charities from making certain social investments where other investors stand to benefit from the transaction. We now consider each in turn.

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31 A social impact bond, for example, may be entered into as a PRI, with the charity trustees focusing principally on the social benefits it is expected to produce, or as a financial investment occupying the space for higher-risk investments as part of a balanced portfolio. If the social good expected to be produced by the social impact bond includes, but also goes beyond, achieving the charity's purposes, the charity trustees may treat it as an MMI.

32 We also identified a number of non-legal barriers, an examination of which would go beyond the scope of this article: see Consultation Paper (n 11) ch 6.

Charity trustees' power to make social investments

Charity trustees need powers to fulfil their fundamental obligation to carry out the charity's purposes. Some charity trustees do not have the power to make certain social investments,[33] and others are concerned that they might not have the power to do so.

Charity trustees might have an express power to make social investments. If they do, there is no difficulty. But the vast majority of charity trustees who do not have an express power must rely on other powers in order to make social investments.

1. Catch-all powers

Some charities will have a power to do any lawful thing that is necessary or desirable for the achievement of the charity's objects. The power may be expressed in various ways in different charities' governing documents, and we refer generically to such a power as 'a catch-all power'.[34] We concluded that charity trustees with such a power have legal authority to make social investments. However, charity trustees may face difficulties in relying on a catch-all power to make social investments.

Significant uncertainty has been created by the decision in *Rosemary Simmons Memorial Housing Association Ltd v United Dominions Trust Ltd.*[35] The claimant was a charitable housing association whose purposes were to provide housing for people in need and the elderly. It had a catch-all power 'to do all things necessary or expedient for the fulfilment of its objects'. The claimant entered into negotiations with the defendant for the provision of a loan to enable the claimant to build 36 flats to provide housing for its beneficiaries. The claimant then asked the defendant to provide the loan to Roger Simmons Memorial Housing Ltd ('Roger Simmons'), a company which was 'under the control of virtually the same body of persons', to enable it to carry out the development. The defendant agreed, on condition that the claimant guaranteed Roger Simmons' liabilities under the loan, which the claimant agreed to do.

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33 As will be seen below, the main difficulties arise in respect of social investments that are expected to yield a negative financial return, or which pursue both the investing charity's purposes and other purposes.

34 A charitable incorporated organisation has a statutory default catch-all power, which can be excluded by the charity's governing document: Charities Act 2011, s 216(1).

35 [1986] 1 WLR 1440.

Mervyn Davies J held that the claimant's guarantee was void as it had no power to guarantee Roger Simmons' liabilities. He referred to *Baldry v Feintuck*[36] where Brightman J said:[37]

> … it is not open to one charity to subscribe to the funds of another charity unless the recipient charity is expressly or by implication a purpose or object of the donor charity. That must be a correct conclusion, because otherwise any charity could, by a side-wind, defeat and supplant its own particular objects. … Charitable funds cannot be applied to non-charitable purposes.

Mervyn Davies J said that the claimant had no power 'to give away its assets, at any rate to a non-charitable body' and that 'the giving of a gratuitous guarantee is on the same footing'.[38] It did not matter that the claimant was seeing its objects promoted by giving the guarantee. Perhaps most controversially, the Judge said:[39]

> The [claimant] merely received the satisfaction of knowing that work it desired to see carried out would be carried out by a third party. But the plaintiff must advance its own charitable purposes either by its own actions or through its agents or subsidiaries. In guaranteeing [Roger Simmons' liabilities] it was not advancing its interests in this way.

The decision in *Rosemary Simmons* might appear to preclude charity trustees from exercising a catch-all power to make social investments that involve either (a) the charity's purposes being carried out by a third party, or (b) the furtherance of both the charity's purposes and other purposes. That would exclude many social investments from the scope of the power.

We respectfully disagree with the decision in *Rosemary Simmons*, and with the Judge's comments insofar as they would support arguments that social investment is prohibited. First, the statement that a charity must advance its purposes either itself or through its agents is unduly restrictive. It is well-established that charities are able to make grants so as to enable their charitable purposes to be advanced by third parties. Charities are not, in our view, precluded from making social investments simply because the charity's purposes are carried out by a third party.

Second, a charity's funds need not be used exclusively and directly to pursue the charity's purposes. A charity's financial investment in a public listed company is

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36 [1972] 1 WLR 552.

37 ibid, 558.

38 [1986] 1 WLR 1440, 1446.

39 ibid.

extremely unlikely to pursue the charity's purposes directly. Rather, the investment is made because it is expected to generate a financial return which the charity can then use to pursue its purposes. Similarly, charities are not precluded from making social investments that pursue both the charity's purposes and other non-charitable purposes; such social investments may be justified on the basis of the expected financial return to the charity.

We suggest that the claimant in *Rosemary Simmons* was permitted by its catch-all power to guarantee Roger Simmons' liabilities, since the guarantee was given to further the claimant's charitable purposes. Further, for the reasons given above, *Rosemary Simmons* should not be interpreted so as to preclude charities from making social investments. But in any event, we suggest that *Rosemary Simmons* ought to be confined to its particular facts; most social investments, after all, will not involve charities guaranteeing a third party's liabilities.

In summary, the problem with using a catch-all power to make social investments is largely one of perception. We consider that a catch-all power is sufficient to enable charities to make social investments, but we acknowledge that there are doubts amongst charity trustees and their advisers as to whether this is correct. And even if they overcome those doubts, as a result of *Rosemary Simmons*, third parties dealing with charities often prefer to see a tailored power in a charity's governing document that caters for the proposed transaction, rather than relying on a catch-all power,[40] which may preclude proposed social investments from being made.

2. The power to spend

Charity trustees' power to spend their charity's funds in furtherance of the charity's purposes will often allow them to make social investments. If charity trustees can spend funds in the pursuit of the charity's purposes, it is difficult to see why they cannot structure their spending in such a way as to achieve a financial return. Nevertheless, we accept that if charity trustees are making an 'investment' (in that they expect a positive financial return, on which see below) there may be an argument that they cannot use a power to 'spend', since they are not divesting themselves of the charity's money. In addition, the power to spend can only be used if the funds spent are used solely to pursue the charity's purposes. A charity for the relief of poverty in London cannot spend money on a

40 For example, we have heard that, before being willing to lend money to a charity, lenders will often want to see an express power to borrow in the charity's governing document and will not be satisfied if the charity simply has a catch-all power.

project that relieves poverty in both London and Birmingham.[41] Similarly, such a charity cannot make a social investment in a project that relieves poverty in London and Birmingham using exclusively the power to spend.

3. The power to invest

Most charity trustees will have a power to invest the charity's funds either expressly under the charity's governing document or - in the case of charitable trusts - under section 3(1) of the Trustee Act 2000. But what is the meaning of 'invest'? The Trustee Act 2000 does not contain a definition. The Law Commission report that preceded the Trustee Act 2000 stated that this was deliberate: 'the notion of what constitutes an investment is an evolving concept, to be interpreted by the courts'.[42] We suggest that an 'investment' is something from which one expects a positive financial return, but not necessarily a market rate of return.[43] Conversely, as suggested by the authors of *Underhill and Hayton*, 'the purchase by trustees of depreciating chattels for a villa that is trust property or the purchase of a depreciating car for use by a beneficiary would not amount to an investment'.[44]

So a social investment from which charity trustees expect a positive financial return can, we suggest, be made using a power to invest. If, therefore, the poverty relief project operating in London and Birmingham is expected to yield a positive financial return, it could be made by a charity whose objects were limited

41 See *Baldry v Feintuck* (n 36). We agree that charity funds can only be used to pursue one or more of the charity's purposes where the charity is completely divesting itself of those funds.

42 Law Commission, *Trustees' Powers and Duties* (Law Com No 260, 1999) para 2.28, fn 56.

43 This is consistent with the reasoning in *Cook v Medway Housing Society* [1997] STC 90, which concerned a housing society that let out its housing stock at a low rent. The court decided that its business involved 'the making of investments' within the meaning of the relevant tax legislation since the housing portfolio was intended to make a profitable capital and income return, albeit below the market return. See also *Harries v Church Commissioners* [1992] 1 WLR 1241, 1246, and *Marson (Inspector of Taxes) v Morton* [1986] 1343, 1350. There is a more restrictive view that the power to invest can only be used where the expected financial return is the best that could be obtained. Conversely, there is a more liberal view - based on the Privy Council's decision in *Culverden Retirement Village Ltd v Registrar of Companies* [1997] AC 303 - that something from which a negative financial return is expected may be an investment when considered holistically with other non-monetary benefits that it is expected to yield.

44 D Hayton, P Matthews and C Mitchell, *Underhill and Hayton: The Law of Trusts and Trustees* (18th edn, LexisNexis Butterworths, 2010) para 49.9.

to poverty relief in London using a power to invest.[45] But an interest-free loan, or a transaction from which charity trustees expect only partial repayment of the capital outlay, could not be made by that charity using the power to invest, since a neutral or negative financial return would be expected. Additionally, if a social investment is particularly high-risk, it may not be possible for the charity trustees to conclude that a positive financial return is expected, in which case the power to invest would on its own be insufficient.

4. Combining the power to spend and the power to invest

Accordingly, there will be social investments for which neither the power to invest nor the power to spend is sufficient. But can such social investments be made by using those powers in combination? The Law Commission's view is that they can. Charity trustees expect from a social investment some financial return and some mission benefit.[46] Those elements of the transaction can be separated, and the former made by using the power to invest, and the latter by using the power to spend; the transaction as a whole is therefore within the scope of the charity trustees' powers. We regard this approach as logically sound if somewhat artificial.

This approach solves the problem of a social investment which is anticipated to produce a negative financial return. It also solves the problem for the charity mentioned above wishing to make a social investment in a project that aims to relieve poverty in both London and Birmingham (even if a negative financial return is expected).

In summary, we suggest that charity trustees can combine their powers in this way to make social investments, but acknowledge that lawyers may take different views,[47] and that there is no case law confirming the point.

5. Amending a charity's governing document

If charity trustees have a power to amend their charity's governing document, they may not need a default power to make social investments; charities can be

45 Whether it would be appropriate to do so, in accordance with the charity trustees' duties, is a separate question, depending on the financial return and the extent to which the charity's purposes would be furthered by the investment. We consider charity trustees' duties when making social investments below.

46 By which we mean the furtherance of one or more of the charity's purposes.

47 For example, the implication behind J Warburton, D Morris and NF Riddle, *Tudor on Charities* (9th edn, Sweet & Maxwell, 2003) para 6-026 is that the powers to spend and invest are separate and cannot be used concurrently to make a social investment.

expected to amend their governing documents so as to confer an express power to make social investments. This is, however, only a partial solution. Some charity trustees will not have a power to amend their charity's governing document, at least not without significant expense and delay.[48] If charity trustees wish to make a social investment, the prospect of having to effect an amendment to the governing document might dissuade them from proceeding. The Law Commission therefore concluded that leaving charities to amend their governing documents is not a solution to the problem concerning charity trustees' powers to make social investments.

6. Recommendations for reform

The Law Commission's view that charity trustees with the powers to invest and to spend, or a catch-all power, are currently permitted to make social investments is not universally held. There is no case law directly affirming this view; rather, it is based on logical inferences drawn from various principles of trust, company and charity law. In addition, charity trustees who are not endowed with some or all of the above powers may not be able to make certain social investments.

In light of the uncertainty concerning charity trustees' power to make social investments, the Law Commission recommended that a default statutory social investment power be created. There was overwhelming support from consultees for the introduction of such a power.

A new statutory power should overcome charity trustees' concerns about their power to make social investments. But the introduction of such a power would only get them so far. How should charity trustees exercise the power consistently with their duties? And how do limitations on the expenditure of permanent endowment, and the law relating to private benefit, constrain the making of social investments? These are issues to which we now turn.

Charity trustees' duties when making social investments

Charity trustees owe extensive duties to their charity. These duties are imposed by the charity's governing document, the common law and statute; and they are enforced by the courts, the Charity Commission and the Attorney General. They range from the broad, and well-known, duty to act in the charity's best interests,[49]

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48 The difficulties faced by charities incorporated by royal charter or by statute in amending their governing documents are being considered in the second stage of our project: see below.

49 For charitable trusts, see *Harries v Church Commissioners* [1992] 1 WLR 1241; for charitable companies, see Companies Act 2006, s 172(1) (as altered by s 172(2)).

through to the specific duty on charity trustees to have regard to the Charity Commission's guidance on public benefit 'when exercising any powers and duties to which the guidance is relevant'.[50] Charity trustees must comply with these duties when they make social investments, whether pursuant to an express power or otherwise. To a large extent this is unproblematic. However, there are two particular issues which cause difficulties for charity trustees making social investments and which we sought to address in our recommendations for reform.

1. Charity trustees' duties when investing

There is a perception amongst some charity trustees and their advisers that social investment conflicts with a supposed duty always to get the best financial return from investments. It arises from the decisions in *Cowan v Scargill*[51] and *Harries v Church Commissioners*.[52]

Cowan v Scargill

Cowan concerned the investment of a mineworkers' pension fund. Half of the trustees of the pension fund were appointed by the National Coal Board and half by the National Union of Mineworkers. Arthur Scargill was elected President of the National Union of Mineworkers in 1982, and at the same time became a trustee of the pension fund. As a newly-appointed trustee, he refused to approve an investment plan which included overseas investments and investments in oil. The other trustees appointed by the Union followed suit. At the same time as leading the Union into the 1984-1985 miners' strike, Arthur Scargill spent two weeks in the High Court arguing, in person, that the position taken by the Union trustees was a matter of Union policy and was for the benefit of the beneficiaries of the pension fund.

Sir Robert Megarry VC held that the Union trustees were in breach of their fiduciary duties. He said:[53]

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50 Charities Act 2011, s 17(5). The guidance is contained in three documents: *Public benefit: The public benefit requirement* (PB1); *Running a charity* (PB2); and *Reporting* (PB3). The duty to have regard to the guidance was first imposed by Charities Act 2006, s 4(6). The guidance itself has a chequered history: the first edition was successfully challenged in the Upper Tribunal (Tax and Chancery Chamber) in *R (Independent Schools Council) v Charity Commission for England and Wales* [2011] UKUT 421 (TCC), [2012] Ch 214, as a result of which the Charity Commission has issued revised guidance.

51 [1985] Ch 270.

52 [1992] 1 WLR 1241.

53 [1985] Ch 270, 286-287.

> the starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust … When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question …

He said that trustees can take into account social and political matters only if it is not to the financial detriment of the beneficiaries,[54] and concluded that imposing blanket prohibitions on certain investments would not assist the Union trustees to pursue the beneficiaries' best interests.[55]

Harries v Church Commissioners

Harries is the leading case on the investment of charitable funds. It involved a challenge to the Church Commissioners' investment policy. It was argued that the policy placed too much emphasis on financial considerations, and should take into account non-financial considerations based on the promotion of the Christian faith and Christian morality.

Sir Donald Nicholls VC dismissed the challenge. He said that the trustees' duties were to further the purposes of the trust. In relation to investment funds:[56]

> prima facie the purposes of the trust will be best served by the trustees seeking to obtain therefrom the maximum return, whether by way of income or capital growth, which is consistent with commercial prudence. That is the starting point for all charity trustees when considering the exercise of their investment powers. Most charities need money; and the more of it there is available, the more the trustees can seek to accomplish. … In most cases the best interests of the charity require that the trustees' choice of investments should be made solely on the basis of well-established investment criteria …

The Vice Chancellor said that trustees should not invest in an organisation that conflicted with the charity's objects, and they could decline to make an investment if it would hamper the charity's work (for example, by alienating the charity's supporters). Beyond that, trustees can only consider moral matters when making

54 ibid, 287.

55 ibid, 294-295.

56 [1992] 1 WLR 1241, 1246.

investment decisions 'so long as the trustees are satisfied that course would not involve a risk of significant financial detriment'.[57]

Conclusion

Cowan did not concern a charity, but a private pension fund. And being a pension fund, the best interests of the beneficiaries were naturally their best financial interests. The Vice Chancellor confined his reasoning to trusts 'for the provision of financial benefits'.[58] Charities are not 'for the provision of financial benefits'; they are for the furtherance of particular charitable purposes. We therefore suggest that the case does not place a duty on charity trustees always to secure the best financial return from their investments.

Harries, on the other hand, did concern a charity, but its purposes were '[to provide] financial assistance for clergy of the Church of England'.[59] The investment duties of the trustees were therefore more akin to the duties of pension fund trustees. Furthermore, when formulating his reasoning the Vice Chancellor clearly did not have social investment in mind. He was not considering investments that would, in part, directly further the charity's purposes, but rather investments that would be made purely for money's sake. His statement that 'trustees cannot properly use assets held as an investment for other, viz, non-investment, purposes'[60] must be seen in that context.[61]

We consider that charity trustees' general duty to act in the charity's best interests requires them to consider the *overall* return from a social investment, in terms both of its expected financial return and of the extent to which it is expected to further the charity's purposes. They are not required to seek a market rate of financial return. Nevertheless, there is a view that charity trustees cannot make social investments unless they are expected to achieve a market rate of financial return,

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57 ibid, 1247.

58 See [1985] Ch 270, 288-289.

59 [1992] 1 WLR 1241, 1248.

60 ibid, 1247.

61 The Law Commission's conclusions concerning the duties of trustees when making financial investments are set out in its recent report, *Fiduciary Duties of Investment Intermediaries* (Law Com No 350, 2014) ch 6. That report did not concern social investment, but pure financial investment. The Law Commission concluded that 'the primary aim of [trustees'] investment strategy should be to secure the best realistic return over the long-term, given the need to control for risks' (para 6.23), and explained the relevance of 'financial factors' and 'non-financial factors' to trustees' decision-making.

and the dearth of case law concerning social investment does nothing to stymie this concern.

2. Charity trustees' duties under the Trustee Act 2000

Where charity trustees are trustees in the technical legal sense (and not, for example, company directors), they owe certain duties under the Trustee Act 2000 when exercising a power of investment. Principally, and most problematically, they must consider the 'standard investment criteria', namely the suitability of an investment and the need for diversification of investments.[62] This gives rise to problems in the case of social investment, since the focus of the standard investment criteria is on financial risk and return; they ignore the extent to which a social investment furthers the investor's charitable purposes. Very often, a social investment will not fare well under the standard investment criteria, since it might be high-risk, have a low financial return, or be unusually large within an investment portfolio.

The Trustee Act 2000 also requires trustees exercising an investment power to take advice about the way in which the power should be exercised (unless they reasonably conclude it is unnecessary or inappropriate to do so),[63] and to review their investments periodically.[64] Consultees generally considered that these duties were unproblematic for charity trustees when making social investments, and that they should be retained.

A further difficulty for trustees under the Trustee Act 2000 is ascertaining when it applies. The duties bite when trustees are 'exercising any power of investment'. So it will apply to social investments when they are 'investments', that is, when they are expected to produce a positive financial return. Charity trustees will not always be able to say with confidence whether or not a positive financial return is expected, and will therefore be uncertain as to whether the Trustee Act investment duties apply.

3. Recommendations for reform

The Law Commission recommended that, alongside the creation of the statutory power to make social investments, three statutory duties should be placed on all charity trustees, and that these duties should apply in place of trustees' investment duties under the Trustee Act 2000 (insofar as they would otherwise apply).

62 Trustee Act 2000, s 4.

63 ibid, s 5.

64 ibid, s 4(2).

- First, when making a social investment, charity trustees must be satisfied that it is in the best interests of the charity, having regard to the expected overall benefit to the charity, comprising the expected mission benefit[65] and the expected financial return.
- Second, charity trustees must review the charity's social investments periodically and consider whether they should be varied.
- Third, when making a social investment and when reviewing an existing social investment, charity trustees must consider taking advice.

The creation of these duties, and the exclusion of the investment duties imposed by the Trustee Act 2000, overcomes the two difficulties outlined above.

The statutory duties, together with the statutory power, refer explicitly to both the expected financial return and the furtherance of the charity's purposes; charity trustees must consider - and balance - both considerations. This would put paid to the mistaken notion that charity trustees are required, when making a social investment, to seek the best financial return to the exclusion of other considerations.

The difficulties presented by the standard investment criteria under the Trustee Act 2000 are overcome by replacing them with a tailored duty that is appropriate for social investment. Trustees should not, therefore, be hampered by having to consider diversification of investments - and potentially justify what appears to be an inappropriate investment from a purely financial point of view - when making a social investment. Nor would they face uncertainty as to whether or not the duty applies, which presently depends on whether a given transaction is an 'investment'. Rather, the Law Commission's recommendation is that the duties should apply to all social investment by all charity trustees, regardless of (a) whether they are - technically - trustees; (b) the particular power that they use to make the social investment; and (c) whether the social investment falls within the definition of an 'investment'.

We concluded that the duty to review investments is appropriate for social investment, and our recommendations replicate this duty in respect of all social investment by charities.

Similarly, we concluded that the duty to consider obtaining advice is appropriate for social investment, albeit that the Trustee Act 2000 duty should not simply be replicated, but should be subject to two modifications. First, advice should not be limited to financial advice; charity trustees may wish to obtain advice on only the

65 See n 46 above.

financial aspects of a social investment, but they may instead wish to obtain advice on the extent to which a social investment furthers the charity's purposes, or on both aspects of the social investment. Second, there should be no presumption that charity trustees ought to obtain advice, but rather a requirement that they consider - from a neutral starting point - whether to seek advice on a social investment. When charity trustees are engaged in financial investment, advice is to be encouraged and can usually be expected, but the same is not necessarily true in respect of social investment. Social investment by definition involves charity trustees forming a judgement about how a charity's purposes are to be furthered. That is central to charity trustees' role, and it is something on which they do not usually take advice. We therefore do not consider that there should be any expectation that charity trustees should take advice when making social investments; whether it is appropriate to do so will depend on the social investment in question.

The Law Commission's recommendations would create up-to-date duties tailored to social investment and provide charity trustees with much-needed certainty as they go through the process of deciding whether or not to make social investments.

Restrictions on the expenditure of permanent endowment

We have heard that many charity trustees believe that they cannot make social investments using permanent endowment. Permanent endowment, in relation to a charity, is property which cannot be spent in the furtherance of the charity's purposes and which must either be retained as a direct means of furthering the charity's purposes, such as a village hall (sometimes referred to as 'functional' permanent endowment) or invested to produce an income ('investment' or 'non-functional' permanent endowment).[66] Our project only considered the social investment of 'investment' or 'non-functional' permanent endowment, and references hereafter to permanent endowment should be read accordingly.

We consider that, in principle, charity trustees are permitted to use permanent endowment to make any social investment that is expected to preserve the value of the endowment capital invested. Such investments do not infringe the rule that the endowment cannot be spent in the furtherance of the charity's purposes. Although the investment may produce relatively little income (when compared to its commercial equivalent), this is a justifiable trade-off for the mission benefit that the investment is expected to deliver.

66 Charities Act 2011, s 353(3) provides that 'a charity is to be treated for the purposes of this Act as having a permanent endowment unless all property held for the purposes of the charity may be expended for those purposes without distinction between - (a) capital, and (b) income; and in this Act "permanent endowment" means, in relation to any charity, property held subject to a restriction on its being expended for the purposes of the charity'.

It will usually be possible to use permanent endowment to make a capital-preserving social investment using the power to invest; as explained above, an 'investment' is anything from which a positive financial return is expected. However, in light of the differing views as to the scope of the power to invest, we recommended that the new statutory power to make social investments should explicitly apply in respect of permanent endowment.

Some consultees suggested that the law should be reformed to permit charity trustees to use permanent endowment to make social investments from which they expected a negative financial return, subject to the recoupment of any capital losses.

This approach would effectively permit charity trustees to use permanent endowment as an overdraft facility for making social investments which are expected to lose money. While we acknowledge the desire for charity trustees to be able to use permanent endowment creatively and flexibly, we are also mindful that permanent endowment is primarily designed to ensure stability and continuity, and of the need to respect the wishes of donors. If charity trustees wish to 'borrow' for the purpose of social investment then they generally ought to do so using their charity's unrestricted funds or, failing that, by following the established procedures for the release of the restriction on the expenditure of permanent endowment set out in sections 105 and 281 to 284 of the Charities Act 2011.[67]

Other consultees suggested that charity trustees should be able to use permanent endowment to make social investments with an expected negative financial return provided that expected losses were offset by expected gains elsewhere in the permanent endowment investment portfolio. We refer to this as 'portfolio offsetting'.

We see the attraction of this approach, but we regard it as difficult to operate in practice. It would be necessary to devise a statutory scheme that permitted portfolio offsetting. There are numerous ways in which charity trustees might wish to carry out portfolio offsetting, depending on the nature of their investment portfolio and the proposed social investments, and their plans for the charity's future. Any statutory scheme would therefore have to confer a significant discretion on charity trustees to allow them to devise an appropriate and tailored

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67 Under Charities Act 2011, s 105 charity trustees can obtain an order of the Charity Commission sanctioning the expenditure of permanent endowment, with or without recoupment. Under Charities Act 2011, ss 281-284 charity trustees can resolve to free part or all of their charity's permanent endowment from the restrictions on capital expenditure; small charities do not need to obtain the prior consent of the Commission, whereas large charities must do so.

offsetting strategy, whilst also regulating their decision-making to ensure that the permanent endowment is protected. We are also concerned about adding layers of complexity to the law, since there are already mechanisms available to charity trustees under the current law that enable them to release the restriction on the expenditure of permanent endowment which would allow them to carry out portfolio offsetting.[68]

We felt that the suggestions for reform set out above indicated a more general dissatisfaction with the law relating to the use of permanent endowment, in particular the requirements for the release of the expenditure restrictions. We therefore concluded that the terms of reference for the Law Commission's charity law project should be expanded to include a more general review of the existing procedures under which those restrictions can be released, rather than focusing on the creation of a mechanism specifically for social investment.

The law relating to private benefit

The law relating to private benefit is controversial.[69] It is fundamental to the legal definition of a charity. Charities must exist for the benefit of the public. If an organisation exists for the sake of the benefits it confers on private individuals,[70] it cannot be a charity. There is an abundance of case law concerning the question of whether or not an organisation is charitable or whether it exists for the benefit of its members, which considers organisations ranging from agricultural societies to athletic associations.[71]

If an organisation cannot be a charity when its purposes involve conferring unacceptable private benefit, it is logical to infer that a charity cannot confer

68 See ibid.

69 See e.g. *R (Independent Schools Council) v Charity Commission for England and Wales* [2011] UKUT 421 (TCC), [2012] Ch 214.

70 Otherwise than as beneficiaries of the charity's charitable activities; for example, a homelessness charity necessarily confers benefits on those individuals whom it helps to provide accommodation in the course of pursuing its purposes.

71 *Inland Revenue Commissioners v Yorkshire Agricultural Society* [1928] 1 KB 611; *Re Coxen* [1948] Ch 747; *Re White's Will Trusts* [1951] 1 All ER 528; *Royal College of Surgeons of England v National Provincial Bank Ltd* [1952] AC 631; *Inland Revenue Commissioners v City of Glasgow Police Athletic Association* [1953] AC 380; *General Nursing Council v St Marylebone* [1959] AC 540; *Neville Estates Ltd v Madden* [1962] Ch 832; *Incorporated Council for Law Reporting for England and Wales v Attorney General* [1972] Ch 73; *London Hospital Medical College v Inland Revenue Commissioners* [1976] 1 WLR 613; and *Latimer v Commissioner of Inland Revenue* [2004] UKPC 13, [2004] 1 WLR 1466, 35 and 36.

unacceptable private benefit in the course of carrying out those purposes, including making social investments; it is the corollary of being afforded charitable status. But on that issue - like other issues we have been considering - there is a dearth of case law.

CC14[72] explains that charities making social investments must not confer private benefits unless they are incidental to the furtherance of the charity's purposes. This is consistent with the concept that emerges from the case law concerning charitable status.[73]

There have been suggestions that the law relating to private benefit should be reformed so as to permit charity trustees to confer 'proportionate' private benefits.[74] As the issue falls outside the Law Commission's terms of reference, we did not consult on it and we do not make any recommendations for reform. We have, however, concluded in the course of our work on social investment that the current law relating to private benefit, properly understood and applied, does not preclude charities from making many social investments.

However the private benefit test is framed, whether a given social investment falls one side of the line or the other will always be a question of fact and degree, leaving scope for argument and uncertainty. We are unconvinced by the suggestion that the law be reformed to permit 'proportionate' private benefit since the meaning of the term would be uncertain, and it may even be more restrictive than the current law in some cases. Perhaps more fundamentally, any re-formulation of the private benefit test would, in our view, have to involve a change to the definition of a charity. As noted above, the restrictions on conferring more than incidental private benefit are a consequence of an organisation being, in law, a charity. If those restrictions are changed, so that charities are permitted to confer more than incidental private benefits, the definition of a charity would have to change at the same time; it would be irrational to permit a charity to confer more than incidental private benefit but at the same time to withdraw its charitable status on the very ground that its purposes include the conferral of more than incidental private benefit.

Whilst the issue is outside the Law Commission's terms of reference, it is a point on which the Government is being pressed by Lord Hodgson.[75] It remains to be seen how the Government will respond to his calls for reform.

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72 Above n 28.

73 See ibid.

74 The Hodgson Report (n 7) ch 9, recommendation 5.

75 HL Deb 26 June 2014, vol, 754, col 1370 and following.

Conclusion

At the time of writing, the Law Commission awaits the Government's response to its recommendations for reform to the law relating to social investment. In the meantime, we will turn to the other aspects of our charity law project. We will be considering:

- The procedures by which royal charter charities and charities with statutory governing documents make constitutional amendments,[76] which we have heard are unduly lengthy and complex.
- The regulatory framework for certain charity transactions and dispositions, including the disposal of, or creation of a charge over, charity land; the application of property *cy-près*; the requirement for Charity Commission approval for charity trustees to make ex gratia payments[77] out of the charity's funds; and the remuneration of trustees for the provision of goods to the charity.
- Charity Commission powers, including the authorisation of an equitable allowance in respect of unauthorised benefits to charity trustees; and requiring a charity to change its name as a precondition of registration.
- The powers of the First-tier Tribunal (General Regulatory Chamber) concerning charity law cases, including authorisation of expenditure on proceedings before it; the procedure for references by the Charity Commission to the Tribunal; the powers exercisable when it decides a reference; and the power to suspend the effects of a Charity Commission decision pending the determination of a case.
- Charity insolvency law, in particular the extent to which a charity's liability to creditors can be met from the charity's permanent endowment or special charitable trusts.
- Charity mergers and incorporations, in particular the difficulties that can arise from gifts by will having been made to charities that have merged; the transfer of permanent endowment and the assignment of leases on merger; and the associated use of vesting declarations.

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76 Royal charter charities must apply to the Privy Council for their charter to be amended. Charities with statutory governing documents must use the procedure set out in Charities Act 2011, s 73, whereby an application is made to the Charity Commission for a scheme which must be given effect by way of ministerial order passed either by a positive resolution (in the case of a charity established by a public general Act) or a negative resolution (for a charity established by a private Act) of both Houses of Parliament.

77 Payments that the charity trustees are morally, but not legally, obliged to make (generally, but not exclusively, when they are beneficiaries under a will in circumstances where their legal entitlement does not reflect the testator's intentions).

- Subject to our discussions with Government concerning the expansion of our terms of reference, the existing procedures by which permanent endowment can be released.

We will be publishing a consultation paper on these issues in early 2015. We then intend to publish a final report, including a draft Bill, in 2016. It will then be for Government and Parliament to decide whether, and how, to implement our recommendations.