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## The Charity Law & Practice Review

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# PROBLEMS OF WINDING UP CHARITIES

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The main purpose of this article is to reflect on research into the legal and practical problems of winding up and insolvency of charities.<sup>2</sup> It also considers whether the proposed Charitable Incorporated Organisation (formerly the CII) might assist with some of the practical problems that were identified and become the “default option” for newly registering organisations.

### The Research

The Charity Commission helpfully supplied information on each charity removed from the register over a fifteen-month period between January 1995 and March 1996, a total of 4,373 charities. Of these, the public files on 130 corporate charities that had had an income during the year previous to their removal from the Register were examined. Much of the research also consisted of case studies of charities being wound up or “rescued” where information was provided by practitioners.

“Rescue” is normally associated with financial problems and it is recognised that insolvency is often not the reason for dissolving charities. Indeed, of the 4,373 charities removed from the register just over 25% had assets immediately prior to their removal.<sup>3</sup> Since 1992 the Charity Commission has had the power to

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<sup>2</sup> Yates E., *Winding Up and Insolvency of Charities (Including Rescue Mechanisms)*, Ph.D. Thesis, Liverpool University 1999. Research supervised by Debra Morris, Director Charity Law Unit Liverpool University, to whom thanks also for commenting on the draft of this article.

<sup>3</sup> Of the 1,119 charities with assets 6% became incorporated and assets were transferred to the new charity; 40% transferred a surplus to another charity; 39% used ss.74 and 75 of Charities Act 1993 to transfer property or spend endowment

appoint a receiver and manager where, following enquiry, it is satisfied that there has been maladministration through misconduct or mismanagement or that they should act to protect the present or future property of the charity or ensure its proper application.<sup>4</sup> Some of the cases examined were receiver managerships under the Charities Act.

### **General Findings**

It is unlikely to be of any surprise that the factors that contributed to charities falling into difficulties would include recalcitrant members and problems between staff and trustees as well as trading, VAT and taxation. It was also clear that changes in patterns of Government funding and the changing expectations of beneficiaries in terms of the style of service offered as well as the economic climate also had a part to play in decisions to wind up or dissolve charities. Nor perhaps would it be unexpected that the legal areas of difficulty encountered when the charity was being wound up might include issues around permanent endowment, land and property holding particularly in unincorporated associations. For the trustees there are also inevitable concerns about the possibility of personal liability, a much more complex issue in an unincorporated association.

What was a surprise was the extent to which the quality of technical support that the charity had received may have contributed to the difficulties experienced by the charity or, indeed, impeded a potential rescue. This is explored further in what follows. Some of the factors raised by the research that are peculiar to the winding up of charitable *companies* have been explored elsewhere.<sup>5</sup>

### **Problems Explored**

#### **General**

The 130 corporate charities whose public files were examined had all been removed before the first SORP was introduced in 1995.<sup>6</sup> As corporate charities,

<sup>4</sup> Now Charities Act 1993 ss.18(1)(vii) and 19.

<sup>5</sup> Yates E., *Winding Up Charitable Companies – Special Cases*, [2000] *Insolvency Lawyer* 120 (Issue 3).

<sup>6</sup> *Statement of Recommended Practice on Accounting by Charities*, published by the Charity Commission October 1995.

they had, however, all been subject to the Companies Acts accounting regime<sup>7</sup> including the requirements for a qualified auditor. Many of the Accounts filed were, at best, shoddy and often contained little more than an income and expenditure sheet and the accounts and reports seemed to have been prepared on the basis of providing minimal information. Hopefully the regime recommended by the SORP (as amended) as well as the requirement for Trustees' Reports and Annual Returns should have remedied this situation.

In the charities studied, the unincorporated association provided the greatest number of problems. This was compounded where the governing instrument was inadequately drafted. There were also problems identified around the position and influence of members within charities. These issues are considered below.

### **The Choice of Vehicle**

The governing instrument of a charity establishes it as an abstract entity as well as providing the practical mechanism by which the charity is put into effect.

In today's "risk conscious" environment, considering the complexities and potential liabilities attached to service provision, it was a surprise to find substantial charities operating as unincorporated associations. Finding two very substantial unincorporated service-providing charities in the research was certainly unexpected. One had recently reviewed its governing instrument but not been advised of the dangers of remaining unincorporated. In some cases, the trustees' personal assets had been put seriously at risk as a result of the wrong choice of legal vehicle.

In the charities studied, the unincorporated association provided the greatest number of problems in terms of the charity's ability to deal with internal disputes, the management of meetings and personal liability of trustees. Other issues raised relate to certainty — about property holding, personal liability,<sup>8</sup> and the limits to members' influence.

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<sup>7</sup> Companies Act 1985 Part VII as amended by Companies Act 1989 Part I.

<sup>8</sup> The cases studied demonstrate that trustees are not always protected where the charity is a company, e.g., they may be required to guarantee loans.

From this perspective, the unincorporated association does not impress as a good legal vehicle. These points may contribute to the view of several professionals that unincorporated associations are a nightmare, especially when they are being dissolved. By comparison, because of the statutory framework and considerable body of case law there is more certainty as far as the charitable company is concerned, for example in respect of some of the difficult situations such as removal of directors or members.<sup>9</sup>

### **Drafting Problems/Lessons To Be Learned**

Given the significance of the governing instrument it was surprising to discover the extent to which an inadequately drafted governing instrument, particularly where the legal vehicle was an unincorporated association, caused quite severe practical difficulties for the administration of the charity. Indeed, this was a recurring theme in what was a relatively small number of charities. Some examples follow:

#### **– The Need To Draft For Flexibility And Change**

Perhaps the traditional view of charities, as endowed foundations and with a privileged capacity for perpetual existence, results in some charity advisers failing to recognise the need for change within charity and being aware of the speed with which change may have to occur. Experience suggests that most charities established over the last twenty years are not endowed, but were established to meet a set of social circumstances then existing. The Charity Commission itself recognises that the nature of charity is adaptable.<sup>10</sup> Because the environment in which charities operate is also changing quite quickly, charities will need to change: some may become outmoded and cease carrying out their activities.

This potential for change needs to be reflected in their governing instruments, which should include power to amend the constitution and power to dissolve them as well as clear methods for doing both of these.

<sup>9</sup> It would nevertheless be good practice for these matters to be covered in the governing instrument. See e.g., Charity Law Association Model Documents.

<sup>10</sup> See e.g., RR1 – *Review of the Register of Charities*, RR2 – *The Promotion of Urban and Rural Regeneration*, and RR3 – *Charities for the Relief of Unemployment*, Charity Commission, March 1999.

– Drafting for Practicality of Operation Including Dissolution

It is not too strong to say that several of the charities identified in the research were effectively crippled at some point in their lives by their governing instrument. With hindsight, who could have thought it sensible to construct a charity, unincorporated at that, in which there were potentially thousands of donors, each of whom were members, some of whom had more votes than others or were in different classes of voting, all of whom would be invited to general meetings? If this ever worked in practice, it can only have been because few members were expected to be interested in attending annual general meetings and matters considered were not expected to be contentious. At the point when the charity needed to be able to rely on its governing instrument to provide it with clear guidance and procedures, it failed abysmally. Not only did it fail to create a clear role for members, but the making of arrangements for the general meeting at which the dissolution and sale of assets of the association was in question became fairly horrendous. This impracticability was further compounded by the fact that the powers of sale of the property as set out in the constitution turned out to be ambiguous.

Other inadequacies in drafting in the case studies included failure to provide a mechanism for dissolution and failure to identify alternative destinations for surplus funds on dissolution. Whilst these issues can be resolved by the Charity Commission, the correspondence with them necessary to clarify these matters takes some time during which the charity's assets may be dwindling or at least are not working for charity.

– Drafting to Avoid Conflict (Personnel and Personalities: Passions and Principles)

Inadequate drafting can also result in, or make it difficult to resolve, conflict. For example, the Commission's Report for 1998, commenting on conflict within a particular charity, noted that its constitution, in so far as it provided for elections, was inadequate. This was precisely the focus for the dispute.

The problems that can result from difficulties between personnel whether from conflict between trustees, with staff, with members, or because there is over-dependence on one or two trustees were reflected in the research. To some extent the application of good management practices could have dealt with these before they damaged the organisation. But those involved with charities as members or trustees are frequently individuals with strong principles stemming from personal, religious, or social values and the charity itself will also be likely to have a value base. Such "matters of principle" can lead to erosive conflict

within the trustee body, or between trustees and staff. Whilst a well-drafted constitution will not necessarily prevent conflicts, it may clarify what should be done whether in relation either to the removal of trustees or members, or perhaps suggest a process through which an attempt at resolving conflict may be achieved.

– Selection and Removal of Trustees and Members

The careful selection of trustees is also important. On the one hand equality of opportunity and openness of access are important in respect of trustee bodies, as is new and challenging thinking. But trustees must act together. In balancing these factors, it is important that, when selecting new trustees, care is taken to identify keenness and ability whilst avoiding the bigoted or pig-headed. In the event of a mistake, however, it is important that the constitution is clear about the circumstances in which a trustee can be removed with the minimum of fuss and disruption to the charity.

Similar problems can occur in respect of members. Clearly, by being explicit about the position of members: how they apply and are vetted; what is expected of them in terms of subscriptions or behaviour; and the circumstances and processes by which they can be expelled, the governing instrument can help.

– Policy Development

The National Trust case<sup>11</sup> suggests that the process by which policy decisions (particularly those affecting beneficiaries or members) are made, consulted upon and implemented is also important. This could become more significant for charities involved in providing services through agreements with local authorities and social services where there is a regulatory emphasis on consultation with service users, quality of service provision and transparency, which may increase with the on-going implementation of “best value”. It may not be appropriate to define such processes in the governing instrument, but it might usefully be a topic for bye laws.

### **The Proposed Charitable Incorporated Organisation (CIO) – Will it Help?**

Both the Charity Commission and the Charity Law Association have produced model constitutional documents for charities. Those produced by the Charity

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<sup>11</sup> *Scott & Ors v National Trust for Places of Historic Interest or Natural Beauty & Or* [1998] 2 All ER 705.

Law Association provide mechanisms for dealing with a number of these more problematic areas. One of the issues raised by the DTI's consultation document *Modern Company Law For a Competitive Economy – Developing the Framework* is whether the proposed new legal structure for charities, now known as the charitable incorporated organisation rather than the CII, should be the compulsory structure for incorporated charities. The Charity Law Association response points out that there are many unincorporated charitable associations whose activities would benefit from a more structured constitution, and more certainty about the powers and duties of their trustees and members.<sup>12</sup> The question not posed is, however, whether the unincorporated association should continue to be a valid vehicle for charities.

The Institute of Chartered Secretaries' Report, "Forms of Incorporation For Not-For-Profit Organisations"<sup>13</sup> using figures available in spring 1999 indicates that at the time of the study out of 189,260 charities on the Register 16,076, 8.5% were companies limited by guarantee whereas 30.5%, 57,711 were unincorporated associations, whilst 28,106, 14.9% were governed by trust deed. The data presented indicates, perhaps not surprisingly, that in the higher income band thresholds a larger percentage of charitable companies is represented. Thus that, within the £100,000 to £1m bracket 43% of the charities are limited companies, 67% in the £1m to £10m bracket are companies and 39.4% in the £10m+ band. Whilst the report provides no breakdown between funds held by trusts, or unincorporated associations in these bands, it seems safe to assume that there is a significant amount of funding held by larger charities that are unincorporated associations.

It seems quite possible that when the Charitable Incorporated Organisation structure becomes available, many existing unincorporated charities will wish to convert since there are indications that smaller charities are concerned about the liabilities of trustees.<sup>14</sup> But what of new charities set up after the CIO becomes available? Given the complexities rehearsed above regarding the problems associated with the unincorporated association as a legal vehicle, would it not be beneficial if potential charities were to be actively encouraged to opt for the structure of a CIO rather than registering them as unincorporated associations without question? Indeed, should the CIO become the "default option", used

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<sup>12</sup> See Francesca Quint, *A New Charitable Incorporated Vehicle*, (2000) 6 CL & PR 199 at 208

<sup>13</sup> *Forms Of Incorporation for Not For Profit Organisations*.  
<http://www.nds.co.gov.uk/cld/ICSA.pdf>

<sup>14</sup> *Charities Structure and Governance Report*, Trowers and Hamlins, solicitors 1997.

unless compelling reasons are provided as to why the charity should be an unincorporated association?

### **Technical Support - Some Questions For The Future**

#### **– Availability, Quality and Cost of Advice**

To many, charity law appears to be fusty and complex and is not widely taught. Because of the reluctance to spend good charity money on legal fees, and the fact that few charities would have funds, there is “no money in charity law” especially outside the metropolis or large cities. Thus few practitioners have the incentive to become expert in it. These factors may explain to some degree why so few lawyers have a good grasp of the legal principles in respect of charity and sometimes provide less than adequate legal advice, for example in respect of drafting matters.

It could be argued that because of the Charity Commission’s role as advisers to charity this does not matter. However, it no longer provides pre-registration advice on the drafting of constitutions. It is also possible that the relative inaccessibility of the Commission’s past and current decisions may be part of the problem. The Charity Commissioners themselves recognised the need for their wider dissemination in launching *Decisions of the Charity Commissioners*<sup>15</sup> which was intended to cover a wide range of decisions on points of law, and on individual cases and it is unfortunate that publication of The Decisions has not continued. The Commission is interpreting the law, has concurrent jurisdiction with the High Court on a number of matters, yet its decisions are not readily available to the public or the professions. At least when decisions are published, there is the possibility of argument and discussion of the cases. Arguably, this focus of knowledge at the Commission is not good for the development of charity law or for the sector.<sup>16</sup> The Charity Law Association, *NGO Finance*<sup>17</sup> and *Charity Law and Practice Review* publish or review recent decisions but can it be appropriate that law which is central to a sector worth almost 2% of GDP is so difficult to access and is disseminated largely by lawyers’ gossip? Whilst it is good that there is free advice on charity and trustee matters available from the

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<sup>15</sup> [1993] DCC preface.

<sup>16</sup> Similar points were made by Hill J., *Too Much Recreation at the Commission*, *NGO Finance*, November/December 1997 at p.42.

<sup>17</sup> *NGO Finance* – Incorporating CHARITY Magazine, Plaza Publishing Ltd.



Commission, there is a danger that only Commission staff and lawyers formerly employed there will have sufficient knowledge of charity law as it develops to be able to give advice.

In addition to legal advice, many charities need access to more technical financial and accountancy advice. Not all accountants are familiar with the intricacies of the Charities SORP but there are also a number of areas, such as charity trading, taxation and VAT, that perhaps require a more specialist technical knowledge which some local charities may have difficulty locating.

– Help For The Smaller Charity

For larger charities there may be little difficulty in obtaining appropriate advice, mediation or consultancy. For the smaller charity, even taking into account “*pro bono*” rates, the cost of legal advice can be thought too prohibitive to be justified.<sup>18</sup> Some potential charities will have access to a model constitution provided by a co-ordinating body. For charities which are not part of a national network, it might be worth considering the role of rural community councils (RCCs) and councils for voluntary service (CVSs) which help community and voluntary groups at all stages of their existence. Many already provide assistance with constitutions. Might it not be useful for the Charity Commission to recognise the technical support which these organisations can give and offer additional support and training specifically to that end?

– A Quality Standard for Charity Practitioners?

A number of legal practices and local intermediary bodies such as CVSs and RCCs will be applying to be registered, or already registered, with a quality standard, some with the Legal Service Commission’s Quality Mark. This research indicates that it may be time to consider a quality standard for the various professions (law, accountancy) etc, (whether private or voluntary sector) which advise charities. Could the development of this be a role for the Charity Law Association?

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<sup>18</sup> Law Works for Community Groups might be of help. It would appear that this new SPBG service is available in the London region at present.  
[www.probonogroup.org.uk/Lawworksforcommunitygroups/about.htm](http://www.probonogroup.org.uk/Lawworksforcommunitygroups/about.htm)