

Diversions of Charitable Assets: Crimes and Punishments

The UK Perspective

1 The Legal Framework in the UK

1.1 For charity law purposes there are 3 jurisdictions in the UK: England and Wales; Scotland; and Northern Ireland. Tax plays an important but consequential role. Whereas charity matters are ‘devolved’ to the 3 jurisdictions, tax matters are ‘reserved’ to the UK Government, with complex consequences for charity law. This arises from the fact that for tax purposes the charity law of England applies throughout the UK. England, with the largest charitable sector, thus predominates both in size and law. This paper concentrates on the arrangements in England but it should be borne in mind that the legal and regulatory arrangements in Scotland and Northern Ireland are different (and under reform). (England and Wales form a single legal jurisdiction but for reasons of brevity - only - this paper refers throughout to England.)

1.2 Charity law drives the English system to an extent exceptional even in the common law world. The proper application of charitable assets, and the corollary, their diversion, are thus subject primarily to the requirements of charity law, though of course tax regulations apply in respect of tax privileges. The fundamental principle is that a charity is a body with exclusively charitable purposes. Its resources may therefore only be devoted to its charitable purposes. This may of course be indirect – for example on administrative expenditure – as well as direct – on services to beneficiaries; but expenditure which the trustees, on whom independent responsibility rests, cannot reasonably justify as contributing towards the realization of their charity’s charitable purposes constitutes (unlawful) diversion.

1.3 The regulator of charity is the Charity Commission (CC) (for England and Wales – a new regulator for Scotland, the Office of the Scottish Charity Regulator – known as OSCR – is being set up separately). Originally established in 1853 to fulfill the charity

functions of the Chancery Court, the CC is both a legal body and a regulator, responsible both for applying and developing charity law and for supervising and assisting compliance with it. Its present constitution (as a non-ministerial government department) is based on the Charities Act 1993. A new Charities Bill has however recently been published under which the Charity Commission will be reformed (and made a public body outside government) with a Charity Appeal Tribunal to which its decisions will be appealable. The essential principles of charity regulation will not be changed and this paper does not need to go into the details of the reform proposals.

1.4 The scope of charity continues to be determined (by the Charity Commission) on common law principles derived from the Preamble to the Charitable Uses Act 1601 (the Statute of Elizabeth). The Pemsel 'heads' of charity – poverty, education, religion and other beneficial purposes – continue to apply. (The reform proposals envisage modernizing the 'definition' of charity by setting 12 charitable purposes, but they essentially reflect the scope of charity as it has developed since Pemsel.)

1.5 Broadly speaking an English charity must register with the CC on the basis, among other requirements, that its purposes are exclusively charitable. This focus on the 'purposes' of a charity, i.e. its broad objectives, is key to charity regulation in England. The activities a charity may undertake, using the resources it has, must be directed towards achieving its objectives; but it is for the trustees – alone ultimately – to decide how to try to achieve their objectives. Provided that they can justify their activities, and the expenditure derived to them, as being reasonably directed at their objectives, the law, and therefore the CC as regulator, cannot override their discretion. (Of course for larger charities professional staff play a key role, but at the end of the day responsibility rests with the trustees.) As discussed in the body of this paper what constitutes reasonable justification for the activities and use of assets of a charity is a key regulatory issue. At this stage it is worth emphasizing that the scope of charity – the range of purposes, whether classified into 4 as in Pemsel or 12 as proposed under the Charities Bill, which are accepted as charitable – delineates the sphere of the public interest, public

benefit being the key test of charitable status. The tradition of charities in Britain, as constantly renewed, is to encourage citizen participation for the public good. The discretion the legal framework gives those active in charity encourages initiative and innovation. Regulation must be sensitive to the beneficial diversity of charitable activity.

1.6 Regulation is essentially concerned with ensuring that the activities a charity undertakes, and the application of its assets for those activities, are compatible with its charitable purposes and legal constitution. There is very little in English charity law which sets precise or quantified requirements or rules. For example, the key principle that trustees may not benefit from their charity (from 'their trust') is no more (and no less) than a basic principle – to be broken when appropriate, i.e. when it is in the charity's best interests to do so - for example when a trustee's professional skills are made available to the charity for a reduced fee. (This is of course hedged around with safeguards, including requirements for CC consent – though the reform proposals encourage relaxing this.) What constitutes reasonable expenditure, for example on administration or campaigning, is a matter of judgment – or opinion – not objective calculation of percentages. Integrity is thus a matter of ethos as well as law, reinforced by standards and codes as well as by rules and regulations.

2 Misuse of Charitable Resources

2.1 It is customary to distinguish 3 main forms of charitable activity: service delivery; advocacy; grant giving. While most charities fall predominantly or entirely into one or other of these categories, many engage in 2 or all 3, provided they are compatible with their purposes and powers. Advocacy, for example, covering the range of activities including campaigning, political lobbying, and policy development, is a function which many charities engage in as of right, even as a duty, in pursuit of their charitable purpose(s). Misuse may arise through unlawful behaviour (charity or wider, e.g.

criminal) or through use of resources in a way not justifiable to realize the charity's purposes.

2.2 It hardly needs stating that charities must be law-abiding. Theft or fraud for charitable purposes is no more permissible than for personal or private purposes. Similarly the use of violence for political ends (terrorism as defined in the British terrorism legislation in common with post 9/11 legislation elsewhere) is no more permissible in a charity than a political movement (though New Zealand is unusual in finding it necessary to include this restriction in its draft Charities Bill!). But borderline, definitional issues begin to arise in this context – the line between legitimate political action under pressure and terrorism is notoriously difficult to draw. More generally issues arise in relation to oppressive laws, the familiar example being the propagation of religion in atheist regimes.

2.3 So far as charity law is concerned misuse of resources arises if they are diverted to purposes outside a charity's charitable purpose or on activities not permitted by its constitution. Where the activity is not charitable it is clearly improper as well as unlawful (even if it can be argued that charity law is unduly restrictive in that particular respect – issues have arisen in Britain over, for example, community enterprise and intercommunal conciliation). Where an objective or activity is proper for a charity but not within the particular charity's purposes or constitution questions arise as to the proper remedy (dealt with below in relation to enforcement), even though it has to be regarded as misuse.

2.4 Diversion of charitable assets to private purposes is a particular form of illegality which is central to the notion of misuse. The basic concept of charity lies in the distinction between public and private benefit. Indeed the distinction (together of course with particular historical factors) underlies the development of 2 distinct spheres of not-for-profit law and institutions in Britain, mutuality – member benefit, alongside charity. In recent years the CC has greatly relaxed the rules (with safeguards) prohibiting trustee

benefit to enable some (even all) trustees to be users (beneficiaries). Similarly an element of public benefit, for example in urban regeneration programmes, is acceptable. At the margin, therefore, private benefit is not necessarily misuse. Where and how the rule should be applied in each case is a matter of judgment, resting in England with the CC, subject to appeal to the courts (and in future the CAT).

2.5 Abuse links with inefficiency, perhaps especially in charity. There are major programmes with substantial government involvement (and finance) in Britain to improve the efficiency of charities. Controversy arises over the relationship – over close, even dependent, in the view of some – between the voluntary and charitable sector (VCS, to use the increasingly customary label) and government. More generally the wider public, with an over simple concept of charity and voluntary action, is often suspicious of charities being too much like businesses. Yet the integrity of charity depends on economic, efficient use of resources, linked in the popular mind with minimal administration and fundraising costs (when these are thought appropriate for ‘voluntary’ (volunteer) bodies at all!) In the British view quantified, or percentage, measures of administrative and fundraising costs are inappropriate since the circumstances and therefore needs of charities vary greatly. (The alternative approach of ‘benchmarking’ is thought more promising.)

2.6 Clearly at a certain point inefficient administration becomes abuse – what facilities staff should be provided with, what conditions of service (e.g. pension provision), at work (transport, expenses). At a certain point laxity becomes abuse – if a charity director needs to be provided with a car, what quality, on what conditions. Charity law does not determine such issues. The Charities Act gives the CC power to intervene where there has been ‘misconduct or mismanagement in the administration of a charity’. These concepts are not defined and the extent to which regulatory enforcement is legitimate is a matter of practice, case by case, subject to the oversight of the courts.

2.7 The sector in Britain puts much emphasis on the promotion of standards by the sector itself – ‘self regulation’. While ‘capacity building’ is highly developed, guidelines or standards which might serve to draw the lines between good practice, bad practice and abuse, for example over such administrative expenditure as staff remuneration, are little developed. Fundraising is the area in which self-regulation is most developed, particularly in order to forestall statutory regulation.

3 Regulatory Framework

3.1 Registration is the basis for regulation – the ‘gateway to supervision’ as the CC calls it. This is a significant – and controversial – development of the requirement for charities (with certain exceptions) to register with the CC. When introduced in 1960 the purpose of the registration, with entry onto the Register of Charities set up under the Charities Act of that year, was authoritative confirmation of a charity’s status (with the rights, in particular tax relief, which that status brings) and public information about charities. It is only under the reform introduced by the 1993 Charities Act that systematic regulation of registered charities has been introduced.

3.2 The basis for regulation is the requirement for annual reporting. Regulations made under the 1993 Act provide a statutory underpinning for an annual report of activities and annual accounts by registered charities. They are graduated according to the size (measured by turnover) of the charity, small charities (with a turnover of less than £10,000 a year) being required only to prepare a simple statement of activities and income/expenditure accounts without having to submit them to the CC, with professional reporting and accounting requirements with auditing only required of large charities. The detailed requirements are set out in the SORP (Statement of Recommended Accounting Practice) prepared by the CC under the auspices of the Accounting Standards Board. As its title makes clear the status of the SORP is recommended practice, rather than legally binding prescription; but its CC/ASB basis of course gives it great authority and it is the basis for CC supervision.

3.3 Large charities are required to submit their report and accounts to the CC, together with an annual return, covering regulatory issues (such as trustee benefit). Under the current reform proposals the CC is testing a Standard Information Return (SIR) for the largest charities (with turnovers of over £10m) designed to provide public information on impact.

3.4 In parallel with developments to improve the public accountability of charities, and with it public confidence in them, by regulation, the VCS, with government and CC encouragement, is developing self-regulation. In particular the GuideStar system, developed in the different circumstances of the US IRS reporting requirements, is being developed to reflect British arrangements. This involves participating charities in completing a more extensive annual return in parallel with the CC SORP, the aim being to provide more detailed information on the basis of which charities' performance can be assessed on a comparative basis.

4 The Charity Commission

4.1 As noted at the beginning of this paper, the Charity Commission (CC) has only been transformed into a regulator in recent years. As is implied by the discussion of the concept of abuse above the legal and regulatory roles of the CC are in some ways ill-fitting. But the notion of the misuse of charity resources is long established, being as much the purpose of the 1601 Statute of Elizabeth as the definition of charity as such. Indeed the immediate precursors of the CC as permanent department were the Commissions set up by Parliament to survey the state of charity in the first half of the 19th century, and uncover abuses, in particular diversion of resources to private benefit.

4.2 The essence of the Chancery Court role was determining what objects were charitable, ensuring that charitable resources were devoted to those objects and amending objects which ceased to be fulfillable (by cy pres). Although this essentially common law basis

has been developed statutorily by the Charities Acts of 1960 and 1992 (consolidated into the Charities Act 1993), notably by the introduction of registration under the 1960 Act and the creation of the CC's supervisory investment powers under the 1992 Act, it remains the legal basis for charity law and regulation both by the CC and by the courts overseeing the CC. It remains based to a large extent on trust law both in terms of the scope of charity - court judgments largely concerning the determination of charitable trusts – and governance – trust law regulating the obligations of charity trustees – even though charitable trusts are now the exception, most charities having incorporated company status or, in the case of small charities, unincorporated associated status.

4.3 The reforms introduced by the 1992 Act have grafted a form of administrative regulatory oversight onto the Chancery/trust model. (The current reforms appear to envisage continuing this hybrid, strengthening the regulatory requirements but retaining the common law basis.) Thus, as described in section 3 above, the CC determines what purposes can be regarded as charitable in the modern world, and oversees registered charities' compliance with the obligations of that status. The CC is thus in effect the agency of first instance in keeping 'the law as to charities moving according as to new social need arising or old ones becoming obsolete or satisfied', as Lord Wilberforce expressed it [*Scottish Burial Reform and Cremation Society – Glasgow Corporation* [1968] Ac 138]. In registration it applies this approach (putting emphasis – as the proposed Bill explicitly adopts – on 'analogy' with accepted charitable purposes. For existing charities it exercises the powers of *cy pres* (made more flexible under the Charities Acts) and makes schemes to modernise ineffective purposes. In respect of governance the CC not only determines but develops the law. A notable example is the relaxation of the restriction on trustee benefit which the CC has developed in recent years.

4.4 Part of the impulse to establish and develop the CC model has been the sense that charity law applied inflexibly, especially with the expense and delays of the Chancery Court, inhibited charities. The statutory basis for the CC has been to 'promote and

make effective the work of charities’ (Charities Act 1993 s 1(4).) In particular the basis for the reform of both the CC itself and the legal basis on which it and charities operate has been to provide an enhancing legal and regulatory framework within which charities can flourish and public confidence in charity be maintained. Thus the flexible ‘problem solving’ approach to the requirements of charity law (as in the ‘user trustee’ example quoted) links with the encouragement of good standards and good practice. The CC’s guidance on ‘the Hallmarks of a Well-run Charity’ (CC60 in the CC’s guidance publications) sets out a series of principles of legal compliance and good governance and management which are rooted in the requirement of charity law (for example that trustees must act independently and altruistically) but reflects the ethos of charity (for example in having regard to beneficiaries and donors).

5 Regulatory Oversight

5.1 The regulation of charities has to take account of their essentially independent basis. (Indeed, as the CC emphasizes, ensuring that charities operate independently and that their trustees are not improperly influenced by other bodies or individuals is one component of regulation.) Regulation combines securing compliance with charity law and dealing with abuse and poor practice with enabling charities to be effective and promoting sound governance and accountability. Two aspects of the CC’s role are, so to say, ‘enhancing’, and complement its enforcement role in dealing with abuse. Part of the rationale for this is that preventative action is better than remedial; part however reflects the fact that, as this paper stresses, the line between good practice and abuse cannot be drawn in sharp legal terms.

5.2 Much of the CC’s regulatory work is thus devoted to improving standards of governance and administration through giving advice and guidance (25,000 cases in 2003/04). These frequently arise at the instigation of the charities concerned, it being fundamental to the ethos of the CC to provide a helpful service to registered charities, but many flow from the routine oversight exercised by the CC. The core of this is

scrutiny of the reports, accounts and returns submitted by charities annually.

Compliance and monitoring of the annual returns is a key part of the new regulatory role of the CC. The importance of the transparency and accountability is one of the things the CC emphasizes. Part of the reason is for public confidence, on the basis that it gives public reassurance that charities meet their expectations. But transparency also supports accountability by encouraging the role of the public in raising regulatory issues with the CC, another source of intervention.

5.3 In addition to routine monitoring of returns the CC has developed a programme of review visits to charities. In 2003/04 it carried out over 600 such visits, focusing increasingly on larger and higher risk charities. The aim is to identify matters of law and governance and administration on which the CC can give help and advice – preventative rather than remedial, though enforcement action is in principle a possible outcome of a visit.

5.4 Investigations form a distinctive part of the CC's functions and organization. This has developed out of the CC's general powers of inquiry (reflecting the long tradition of Parliamentary 'roving' Commissioners checking charity abuse) and is a key part of the transformation of the CC into a modern regulator. The CC's powers of inquiry are general and do not depend on any suspicion of wrong doing. In principle they are thus available for general inquiries into any issues relating to charities. In practice the CC uses its powers specifically to deal with issues of concern either arising from the CC's own monitoring or as a result of complaints and concerns raised with it. Before a formal investigation is undertaken the CC conducts an evaluation of the complaint or issues of concern. Only where there is reason to believe that there are problems which need to be addressed is an investigation opened. Registered charities are obliged under the Charities Act to cooperate with the investigation staff, providing any documents or information requested. In 2003/04 the CC undertook 423 investigations.

6 Enforcement

6.1 Issues of concern prompting a formal investigation range widely, from allegations of serious abuse such as fraud (rare) to procedural issues such as non-compliance with reporting obligations. Thus the CC has been conducting a campaign to ensure that charities submit their annual reports and accounts as required under the Charities Act. 95 of the 423 investigations initiated in 2003/04 related solely to the non-production of accounts.

6.2 The CC has substantial enforcement powers. They are however 'remedial', that is, they are directed at correcting the problems identified and putting the charity on a sound footing. The CC has no powers to impose sanctions as such. Where the concerns involve criminal behaviour the CC works with the police, who are responsible for bringing matters to prosecution. Where issues like terrorism and money laundering are concerned the CC cooperates with the relevant intelligence and financial agencies.

6.3 The CC's remedial powers may be used if misconduct or mismanagement has been established or to protect a charity's resources or ensure that they are properly applied. (Such judgments, and the intervention based on them, are of course subject to appeal to the courts.) The powers include replacement of trustees; control over the application of a charity's resources; and the appointment of a receiver and manager to exercise some or all of the responsibilities of the trustees. These powers include removal of a charity's staff well as trustees. The CC may order restitution by the trustees of resources improperly used, especially of course for personal benefit but equally for purposes outside the purposes or powers of the charity.

7 Charity Commission Investigations

7.1 The majority of CC formal inquiries result in actions to improve governance and management. Though usually initiated because evaluation of complaints made to the CC or concerns arising from CC monitoring suggested prima facie that there were

serious issues to address, like personal benefit or misappropriation, the outcome is most commonly identifying and addressing weaknesses, in particular inadequate trustee (board) oversight or financial controls. Thus one may say that formal inquiries are an extension of the CC's 'preventative' role, to encourage good governance and administration and intervene to correct bad practice before serious damage occurs.

7.2 A particular example of this preventative approach is the use of formal inquiries where the legal obligation to submit the annual return of report and accounts has not been met. The CC stresses that compliance is basic to good management and accountability and failure may well be a symptom of deficiencies in the charity. In the great majority of cases it is however no more than laxity and the CC's intervention serves to prompt corrective action. The CC publishes reports on inquiries initiated by failure to submit returns and the 'naming and shaming' of defaulting charities is itself salutary.

7.3 The outcome of CC inquiries, confirmed with the continuing monitoring of registered charities, supports the view that deliberate abuse of charitable status is rare and that problems arise mostly through lack of skills, experience or care. Indeed the premise of charity regulation is that the great majority of trustees are committed volunteers who need support to fulfil their responsibilities and achieve their ambitions for the public good, not confrontational regulation backed by sanctions. Advice and guidance in support of trustees is at the heart of the CC's role.

7.4 Of course public confidence, as well as the wellbeing of charity, depends on reasonable safeguards against deliberate abuse and the CC has to be on the lookout for this. Its monitoring pays particular attention to signs of trustee or other inappropriate benefit. It has published a series of reports on unauthorized trustee benefit. Given the proper flexibility of charity law, and indeed the increasing flexibility of the CC's interpretation of it, trustee benefit is a complex issue. It is often in a charity's best interests to take advantage of a trustee's skills provided there are proper safeguards. Much of the CC's concern is with ensuring that proper arrangements are put in place and checking that the

benefits a trustee has received are acceptable even if authorized respectively. (The new Bill proposes further relaxations to the authorization requirements for trustee benefit.)

7.5 Misappropriation of charity funds, to use the language of a CC inquiry report, does of course occur, though rarely – so far as the cases uncovered suggest – on a very large scale. The CC's report gives examples of cases typically where tax controls have allowed an individual, whether the treasurer or member of staff, to divert funds to his own benefit. Mostly the sums involved amount to some thousands or tens of thousands of pounds. So far as the CC is concerned remedial action consists of restitution, where possible, and improved systems; but of course police investigation and prosecution in serious cases is the action against the perpetrator, leading to sentences of imprisonment. One example, involving exceptional sums, concerned a school administrator who, as a result of failed oversight and controls, was able to divert school funds into her own bank account. She was convicted of theft, after CC and police investigation, amounting to over £140,000 and sentenced to 18 months imprisonment. This case attracted national media attention. Another case illustrating a different, unusual, issue, concerned the director of a charity who misused her position to overclaim expenses. The sums involved amounted to some £10-£20,000; and there were issues about her remuneration. The director was dismissed with consideration given to proceedings against her. This was however complicated by the fact that she was diagnosed as having a mental illness amounting to statutory disability.

7.6 The diversion of charitable funds for terrorism is a special form of abuse of particular concern post 9/11. It is of course not a new issue – terrorism has long been a threat in Britain, domestically connected with Ireland, with concerns over the use of Irish societies abroad to channel funds to the IRA. The strengthening of charity regulation in the 1980s, though driven by more general concerns, also served to improve protection against abuse for terrorism. Even before 9/11 the CC was strengthening its links with other agencies and has played an active part in the work of the Financial Action Task Force (FATF) on money laundering. In practice the CC's 'ongoing work reveals that

connections between registered charities in England and Wales and terrorist organizations are rare'. The CC's inquiry reports reveal a number concerning terrorism arising from CC monitoring, complaints or, in a few cases, concerns raised by other agencies, including US Government agencies. One case, for example, concerns a charity for the relief of poor and needy Palestinians which was listed as a 'Specially Designated Global Terrorist' organization in a US Presidential Decree for allegedly supporting Hamas's political or violence militant activities. The Commission's investigation found no clear evidence showing links to such activities of Hamas, nor was any provided by the US authorities. The most notorious case is that of the North London Central Mosque Trust (NLCMT) and the activities of Abu Hamza there. (Religious bodies are charities under English law.) The investigation found that the trustees had lost control of the mosque and that Abu Hamza was using it to preach extremist views. He was removed under Charities Act powers and new financial and management controls implemented.

8 Conclusion

While the reform of the CC is transforming it into a modern regulator, and the language used to describe it, for example in the current phase of reform, focuses on this, in practice, as this paper has emphasised, the bias of the CC's effort is on advice and prevention. The stance is well-reflected in the words of the CC's outgoing Director of Operations (who had a reputation for encouraging the use of the CC's investigatory powers) when he commented that: 'There is actually very little abuse within the charitable sector.....but we want to crack down hard when it does occur.' It is of course possible that there is more abuse than is uncovered by the CC; but, while some must inevitably escape detecting, it seems unlikely that it significantly affects this judgment.

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