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MEMORANDUM

TO: Legal Task Force

FROM: Timothy R. Lyman, on Behalf of the Foreign Legal Advisor Team

DATE: April 13, 1998

RE: Comments on the Draft Law on Associations and Foundations

INTRODUCTION

As proposed in our memorandum of April 9, 1998, the purpose of this memorandum is for the Foreign Legal Adviser Team (collectively, the "FLAs") to share comments, questions and suggestions with the Legal Task Force (the "LTF") concerning the draft of the proposed Law on Associations and Foundations (the "Draft") forwarded to us in English last week. The discussion below includes matters that one or more of the FLAs felt worth mentioning before the LTF finalizes a version of the Draft to be circulated more broadly. We expect to raise smaller matters, particularly comments, questions and suggestions concerning specific language and phrasing, with respect to that subsequent version of the Draft. In order to get our comments, questions and suggestions on the larger issues to you as soon as possible, this memorandum is being forward to the members of the LTF and the other two FLAs simultaneously. The other FLAs may wish to follow up separately with further comments on some of the issues addressed below.

The comments, questions and suggestions below relate to the text of the Draft, and do not deal with either the separate draft legislation we received addressing only associations or with the explanation of the Draft (the "Explanation"). Although we have focused our critical attention for the time being on the Draft itself, the FLAs would nonetheless like to commend the LTF on the thoughtfulness that is evident in the Explanation.

The comments, questions and suggestions below are grouped as follows: General issues; Issues pertaining to both association-related and foundation-related provisions; Issues pertaining to provisions dealing specifically with associations; and Issues pertaining to provisions dealing specifically with foundations.

GENERAL ISSUES

o **SIMPLIFICATION AND CLARIFICATION:** The FLAs believe that there are ways to simply and clarify the Draft still further. In some cases we make suggestions for structural simplification below (such as with respect to the question of federations) and in some cases we suggest language simplification or clarification (although we intend to save specific language and phrasing suggestions for the review of the next version of the Draft). As a general language-related comment, we would note that in various places there is a lack of parallelism in the language used in different places in the Draft to describe what appears to be the same or a very similar thing. Such differences imply the existence of legal distinctions that are probably not intended.

o **GOVERNMENTAL ROLE:** The Draft creates, in general, quite a large scope for governmental involvement in the affairs of associations and foundations. One FLA noted, further, that the Draft frequently assigns the governmental involvements that it creates to an administrative body, such as a ministry, rather than a judicial body, such as a court. In general, the role for the government that emerges from the Draft is more intensive and discretionary than is common in Western European countries, where the government's role is generally largely ministerial, unless public health and safety or compliance with general laws is at issue.

o **ENTITY RECIPROCITY PROVISIONS:** The provision on the reciprocal freedom of activity of associations and foundations registered in the other Entity (Article 9) seems incomplete to us. It does not deal, for example, with the possibility that an association operating in the other Entity violates the laws of that Entity (other than the Law on Associations and Foundations, which, we have presumed, would be the same in both Entities). It may be the LTF has a clear vision of how reciprocal recognition of associations and foundations registered in the other Entity would work in practice. If so, this vision is not fully evident to the FLAs in the Draft itself as it is currently written.

o **INFORMAL ASSOCIATIONS:** The Constitutional right to form informal associations without any form of governmental approval derives directly from the BiH Constitution and should not have to be reiterated in Entity-level laws. Nonetheless, the FLAs would recommend for inclusion in the Draft's General Provisions a clear statement of the right to establish informal associations that do not have to satisfy the conditions imposed by the Draft upon formal associations that enjoy the status of legal entities.

ISSUES PERTAINING TO BOTH ASSOCIATION-RELATED AND FOUNDATION-RELATED PROVISIONS

o **"NONPROFIT"-RELATED PROVISIONS:** The Draft seems to have a number of gaps in its treatment of the nonprofit status of associations and foundations. The term "nonprofit" is not defined in the Draft. Ambiguities in the wording of the provision in which the term first appears

(Article 4) left the FLAs with questions about the consistency of the two paragraphs in that provision. Perhaps most notably, there appears to be no explicit limitation on distributions of current net revenue to members or other insiders (not even in the case of a "public interest" association, as discussed further below). These gaps are related, and could probably be largely rectified by the addition of a definition of the term "nonprofit" in terms of a general prohibition on the DISTRIBUTION of net revenue. It may also be worthwhile to consider an explicit statement that reasonable compensation and reimbursement of expenses may be paid by associations and foundations, to make clear that such payments would not constitute prohibited distributions.

The FLAs note, also, that because the Draft contains no definition of "nonprofit," it is unclear to what extent mutual benefit organizations can be formed as associations. Indeed, the absence of a prohibition on distributions to insiders leaves questions as to the intended boundary line between associations and cooperatives.

- o PROHIBITED ACTS: One of the FLAs has expressed concern about the second paragraph of Article 5, and suggests that the standards by which the legality of associations' and foundations' activities are judged should be only those standards recognized under relevant international law (which is already applicable to legal entities in both Entities by virtue of the BiH Constitution). The somewhat vague phrase "any other form of discrimination" could actually provide a pretext for governmental suppression of legitimate associational activities that are fully consistent with international norms.

- o ECONOMIC ACTIVITIES AND "PRINCIPAL PURPOSE": The Draft seems to be missing any clear statement concerning associations' and foundations' powers to engage in the sale of goods and services or any limitations on those powers. Also missing seems to be any kind of "principal purpose" discussion that would distinguish associations and foundations from commercial business entities.

- o CONTENTS OF STATUTES AND "DEFAULT" PROVISIONS: The Draft contains no provision stating affirmatively that an association's or foundation's statute MAY include any provision that does not contradict the legally required provisions. Two of the FLAs noted, also, that the Draft includes as requirements provisions that might instead be phrased as "default" provisions (which would only apply in the absence of relevant provisions in the statute of the organization in question). (An example of this would appear to be Article 23, which, although somewhat ambiguously worded, appears to prohibit an association with ten members or less from having a steering board composed of less than all the association's members). Conversely, we note that the Draft appears, not to have certain very useful "default" rules to cover possible gaps in the subjects addressed in the statutes of associations and foundations, such as "default" quorum and voting rules.

o **DUTIES OF BOARD MEMBERS AND INDIVIDUAL LIABILITY:** The Draft contains: (1) no discussion of the duty of loyalty that is legally expected from members, steering board members and other insiders; (2) no discussion of the duty of confidentiality of these individuals; and (3) no sufficient discussion of standard of care required of these individuals in order for them to avoid personal liability, either to the association or foundation in question or to third parties dealing with the association or foundation. (We note that Article 32 does appear to describe the standard of care required of foundation steering board members with respect to the management of the property of a foundation. We saw no comparable provision for associations.) It may be that at least some of these issues are dealt with elsewhere in the Entities' laws, but probably not adequately or in an adequately standardized fashion. On the important issue of individual liability, the FLAs also noted with concern final paragraph of Article 57, which subjects the "representative" of an association or foundation (referred to also elsewhere, but not defined in the Draft) to penalties in the event of certain violations by the association or foundation in question, without any showing that the representative even knew or had any part in the violations.

o **"SELF-DEALING" AND OTHER CONFLICT OF INTEREST PROHIBITIONS.** Anti-"self-dealing" provisions in the Draft appear to be limited to a requirement that interested parties not participate in approving transactions in which they have an interest. It would seem advisable to add a general requirement that such transactions be negotiated at arms' length, and that the insiders receive no more than fair market value.

o **AUDITS, REPORTING AND PUBLIC ACCESS:** The Draft appears to contain no explicit provisions dealing with transparency and public accountability (even in the case of "public interest" associations, as discussed further below). Specifically, there is no discussion of audits, governmental or other reporting obligations (other than as to changes in registration information or statutes), and no public disclosure or access requirements.

o **ADVOCACY ACTIVITIES:** No statements appear in the Draft clarifying the scope of allowable advocacy activities. Specifically, there is no dividing line specified between associations and foundations on the one hand and political parties on the other. The FLAs recommend that the LTF consider a simple-to-apply rule on this subject, such as a statement that associations and foundations may be involved in all forms of policy advocacy, although not in campaigning for elected officials.

o **INTERNATIONAL ORGANIZATIONS:** Provisions on international organizations (for example, Articles 11 and 17) leave ambiguities as to which provisions of the rest of the law do and do not apply to foreign organizations. They also do not address the problem that some foreign organizations (particularly those formed under the laws of countries with common law rather than civil law legal systems) may not be clearly recognized as either foundations or

associations (as these concepts are developed under the Draft's provisions).

- o **TRANSFORMATIONS:** The Draft contains no treatment of transformations from an association or foundation into some other form of legal entity (except by merger).
- o **DISSOLUTION AND DISTRIBUTIONS UPON DISSOLUTION.** The Draft would permit involuntary dissolutions of associations or foundations even for technical and insignificant violations of law or their statutes (Article 51). The lack of any required showing as to the significance of a particular violation would appear to leave associations and foundations with unpopular views vulnerable to vindictive dissolution.

The provisions on the involuntary dissolution of associations and foundations, in addition to permitting apparently too much governmental involvement and discretion, also seem inconsistent. Article 51 appears to permit the initiation of action to dissolve an association or foundation by ANY PERSON, whereas Article 53 appears to require action to be commenced by the Public Prosecutor. Obviously, permitting any person to take action against associations and foundations will leave unpopular organizations subject to constant threat of harassment.

The FLAs noted with concern that the reversion of assets to founders, members, steering board members and other insiders is implicitly permitted in the case of associations and is explicitly permitted for foundations. The prohibition upon the distribution of net assets upon dissolution to such parties goes hand-in-hand with the non-distribution principle discussed above with respect to the definition of what it means to be "non-profit." Allowance of reversions and distributions of net assets upon dissolution is clearly appropriate in the case of mutual benefit organizations. However, as is observed above, these organizations are insufficiently differentiated in the current provisions of the Draft.

- o **PUNITIVE PROVISION:** The Draft's punitive provision (Article 57) seems both too broad in some respects and perhaps too narrow in other respects. The provision would appear to permit harassment of associations and foundations for merely technical or insignificant violations. At the same time, the provision does not correlate the amount of penalty with the type or severity of the violation in question (and includes no maximum penalty for any violation). As mentioned above, the FLAs are also concerned that the provision provides for the punishment of an organization's "representative," without any necessary showing that the representative participated in or even knew about the violation in question.

- o **TRANSITIONAL PROVISIONS:** The Draft's transitional provisions (Articles 58 and 59) are ambiguous with respect to organizations formed and registered as either international or domestic humanitarian organizations (perhaps a problem only in the Federation) and with respect to international organizations not organized as either associations or foundations (see

comments above).

ISSUES PERTAINING TO PROVISIONS DEALING SPECIFICALLY WITH ASSOCIATIONS

o **FOUNDERS AND MEMBERS; FEDERATIONS:** Both founders (Article 12) and members (Article 18) of associations are apparently required under the Draft to be natural persons. In addition to preventing the wide variety of associations that flourish in other countries which include both representatives of legal entities and natural persons among their membership, this limitation makes necessary separate (and we might add, somewhat ambiguous) provisions on federations (Articles 10 and 29). A simpler approach, and one common in other countries, is simply to permit legal entities to serve as both members and founders of associations, in which case a federation can merely be formed as an "association of associations" without the need for special provisions.

o **"PUBLIC INTEREST" ASSOCIATIONS:** The provision of the Draft on "public interest" associations (Article 16) seems to the FLAs to require further thought and more extensive treatment in the Draft. This topic is important and complicated enough to justify the consideration of a separate section of the Draft, rather than only a single Article. (This is the approach taken, for example, in the Bulgarian draft law.) Our concerns with the existing provision include the following:

(1) Both alternative formulations leave associations potentially uncertain as to which ministry or ministries will have jurisdiction to decide whether a given association qualifies as a "public interest" association. This leaves open the possibility of inconsistent approaches among different ministries.

(2) Leaving the decision on "public interest" status in the hands of one or more administrative bodies without any explicit right of appeal will leave associations subject to possible governmental manipulation, particularly in the case of politically unpopular (but possibly socially beneficial) causes.

(3) In general, the Draft lacks discussion of the consequences of "public interest" status. In particular, because such organizations will presumably be entitled to certain beneficial treatment under the Draft and other Entity-level laws as a "reward" for fulfilling a public interest (such as, we imagine, tax benefits, once this issue is addressed in the relevant tax legislation), it is appropriate to require "public interest" organizations to satisfy greater transparency and public accountability requirements than other types of associations. Appropriate special provisions could include different auditing standards, heightened government reporting obligations, and greater public disclosure and public access to the records of activities of such organizations.

(4) The Draft contains no discussion of the ongoing qualification of an association as a "public interest" association. The Draft is silent on such relevant concerns as the possible amendment of the statute of a "public interest" association so that it fails to qualify as such an organization and on the appropriate treatment of net assets of a "public interest" association upon its dissolution.

o **PROPERTY OF ASSOCIATIONS:** The lack of clarity (mentioned above) about the general power to engage in the sale of goods and services (and limitations on such power) is evident in the Draft's provision on the property of associations (Article 43). Moreover, the provision does not address whether foreign funding is permitted.

ISSUES PERTAINING TO PROVISIONS DEALING SPECIFICALLY WITH FOUNDATIONS

o **RELATIONSHIP BETWEEN FOUNDATION-RELATED PROVISIONS AND ASSOCIATION-RELATED PROVISIONS:** In general, the Draft appears to treat foundations as a far more distinct category of organization from associations than the FLAs feel is necessary. As a general observation, it may be useful to think of foundations as organizations very similar to associations, with the major dissimilarity being that the steering board of a foundation is self-perpetuating or chosen in some other manner that substitutes for election by members as occurs in the case of associations. The Draft's provisions on foundations (Article 24 et seq.) are frequently not worded to parallel comparable provisions on associations, leaving ambiguity as to whether the LTF intends a legally significant distinction in the treatment of the two types of legal entity. Perhaps the most important example of this lack of parallelism is the articulation of concepts of "general benefit" and "charitable purposes" with respect to foundations (Article 24) that appear to differ slightly from the concept of "public interest" articulated with respect to associations (Article 16). It would appear to the FLAs that all differences in the Draft between the provisions applicable to foundations and those applicable to associations should be backed by a well-reasoned justification based upon the different governance structure of the two types of legal entities.

o **RELATIONSHIP BETWEEN FOUNDATION-RELATED PROVISIONS AND OTHER BODIES OF RELEVANT LAW:** The FLAs are concerned about the interplay between the foundation-related provisions of the Draft and possibly contradictory provisions of other related bodies of Entity-level laws, particularly laws pertaining to the treatment of gifts, wills, and inheritance.

o **ROLE OF FOUNDERS AND FOUNDATION GOVERNANCE:** The Draft seems to reflect some ambiguity about the appropriate role of a foundation's founders. In particular, clarification is needed that a gift to a foundation (whether by its original founders or subsequent donors) is irrevocable. Founders' rights in the ongoing governance of a foundation should be limited to

those that they may gain by serving as members of the foundation's steering board. (By contrast, the Draft includes, for example, an ambiguous reference in Article 26 to rights of founders that are not transferrable to their successors. These rights are not explained further.) Because founders' rights as founders should end after the foundation in question is formed and registered, provisions for the naming and succession of a foundation's steering board must be clearly provided for.

- o **PROPERTY OF FOUNDATIONS:** The Draft includes no provision on the property of foundations.
- o **ROLE OF GOVERNMENT VIS-A-VIS FOUNDATIONS:** In general, the Draft seems to envision too much governmental involvement with foundations. We wonder, for example, why the advance approval of ANY ministry should be required prior to the formation of a foundation (as is provided in Article 25). We also wonder why any ministry would have a role in appointing the steering board of a foundation (as provided in Article 31)
- o **MERGERS:** The Draft's provision on foundation mergers (Article 29) seems ambiguous to the FLAs (and arguably inconsistent with the Draft's current provisions on associations, which presently do not permit non-natural persons to be members of associations). This provision would be clarified substantially by permitting legal entities, in addition to natural persons, to serve as members of associations (as discussed above), thereby permitting associations of foundations (or, for that matter, associations with a combination of types of members).
- o **DISSOLUTION OF FOUNDATIONS:** In addition to permitting apparently too much governmental involvement and discretion (as mentioned above), the Draft's provisions on the dissolution of foundations specifically PERMIT the reversion of a foundation's assets to its founders. As noted above, the decision to form a foundation should be an irrevocable one.

The FLAs also noted the apparent ambiguity as to when a foundation's dissolution would be voluntary. In particular, Article 49 leaves question as to whether the various reasons for dissolving a foundation cited there could be the basis for an involuntary dissolution by a governmental authority. In general, the FLAs believe involuntary dissolutions should be precisely and narrowly phrased and that a foundation's steering board should have broad freedom to dissolve the organization voluntarily. The Estonian Law on Foundations may provide a useful frame of reference for these principles.