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Letter from the Editor 4

Not-for-Profit Law and Culture in Asia

*Globalization, Glocalization, and Galápagos Syndrome:
Public Interest Corporations in Japan*
Masayuki Deguchi 5

*Charity Law Reform in Hong Kong:
Taming the Asian Dragon*
Damian Bethke 15

Articles

*Freedoms of Association and Assembly
and NGO Regulation in Greece and England*
Konstantinos D. Magliveras 40

A Framework for Analysis of Islamic Endowment (Waqf) Laws
Mohammed Obaidullah, Ph.D. 54

*The New York Nonprofit Revitalization Act,
from the Foundation of the Sarbanes-Oxley Act to Implementation*
Isida Tushe 65

*What Nonprofit Board Members and Managers Don't Know
Can Hurt Them Financially:
IRS Form 990 and the Intermediate Sanctions Act*
Eugene H. Fram, Ed.D. 78

Letter from the Editor

In this issue, the *International Journal of Not-for-Profit Law* features two articles on Asian not-for-profit law, with particular attention to the historical and cultural elements that shape it. **Masayuki Deguchi**, a Professor at the National Museum of Ethnology and SOKENDAI (the Graduate University for Advanced Studies), Japan, draws on his past experience as on the Public Interest Corporation Commission to assess the origins, structure, and regulation of the Public Interest Corporation in Japan. **Damian Bethke**, who recently completed his Ph.D. at the Chinese University of Hong Kong, outlines the distinct culture of giving in Hong Kong as a basis for evaluating proposed reforms to charity law.

Other articles in the issue examine a variety of topics. **Konstantinos D. Magliveras**, a Professor in the Department of Mediterranean Studies at the University of Aegean, Greece, analyzes similarities and differences between Greece and England in terms of freedom of association, freedom of assembly, and the regulation of nongovernmental organizations. **Mohammed Obaidullah, Ph.D.**, a Senior Economist at the Islamic Research and Training Institute of the Islamic Development Bank Group in Jeddah, Saudi Arabia, and a Professor in Islamic Finance at Islamic Science University of Malaysia, develops and applies an analytical framework for Islamic endowment laws. **Isida Tushe** of Hofstra University provides an overview of the New York Nonprofit Revitalization Act. Finally, **Eugene H. Fram**, Professor Emeritus at the Saunders College of Business, Rochester Institute of Technology, outlines the Intermediate Sanctions Act in the United States and the obligations it imposes on board members and managers of not-for-profit organizations.

We gratefully acknowledge the assistance of anonymous referees who helped with some of the articles. Most of all, of course, we thank the authors for sharing their expertise, and we invite readers to share their own expertise. The *International Journal of Not-for-Profit Law* welcome manuscripts addressing legal aspects of civil society, philanthropy, and not-for-profit organizations around the world.

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Not-for-Profit Law and Culture in Asia

**GLOBALIZATION, GLOCALIZATION, AND
GALÁPAGOS SYNDROME:
PUBLIC INTEREST CORPORATIONS IN JAPAN**

MASAYUKI DEGUCHI¹

To facilitate public interest activities by private entities, some countries, including Ireland and New Zealand, have inaugurated Charity Commission-style independent regulators of the type that originated in England and Wales. In the first attempt far from the Commonwealth's culture, Japan has launched the Public Interest Corporation (PIC) Commission. The aim of the Japan's reforms, the first revision since establishment of the Civil Code 1886, is to abolish unclear discretionary regulations and to make clearer stipulations in the laws. The author witnessed the policy as Commissioner in Japan for six years. This article summarizes and evaluates the reforms, with a focus on the interplay between globalization, "glocalization," and "Galápagos Syndrome."

I. Introduction

There is a consensus in many countries around the importance of public interest activities by private entities (Cordery & Morgan 2013). Encouraging the public interest sector is an aspect of public policy. It is, however, difficult to define "public interest." Some countries assign the task to independent agencies, such as the Charity Commission in England and Wales (Cordery 2013).

Japan has adopted the independent commission style by launching *Koeki Ninteinto Iinkai* (Public Interest Corporation Commission or PIC Commission) as part of the reforms of *Koeki hojin* (Public Interest Corporation or PIC). The reform in 2006 was the first substantial change to the Civil Code on nonprofit corporations since the establishment of old Civil Code in 1896.

This article provides an overview of Japan's PIC reforms, with particular focus on the influence of globalization, "glocalization," and "Galápagos Syndrome."

II. History of the Nonprofit Legal System in Japan

Japan's legal system for "public interest"² and for not-for profit organizations dates back to the old Civil Code, adopted in 1896, and carries forward into the 2006 Civil Code. Article 34

¹ Professor, National Museum of Ethnology, and SOKENDAI (the Graduate University for Advanced Studies), Japan; former Commissioner, Public Interest Corporation Commission; former President, ISTR (2005-2006).

A version of this paper was presented at the 11th International Conference of the International Society for Third Sector Research in 2014, in Muenster, Germany. Travel expenses were supported by the MINPAKU Director-General's Leadership Program. The author would like to thank Professor Kenich Kudo, Director-General of MINPAKU, for generous support.

divides Public Interest Corporations (PICs)³ into two categories: the *shadan hojin*, or incorporated association; and the *zaidan hojin*, or incorporated foundation (Amemiya 1998). The association is formed as a group of members, whereas the foundation is formed around an endowment and, legally, does not have members (Larratta & Mason 2010).

Some PICs pursue only a quasi-public interest (Moriizumi 1977; Tanaka 1980; London 1991). In addition, the concept of the public interest has varied over time. The activities of some PICs, accordingly, have been almost indistinguishable from those of for-profit organizations (London 1991; Ministry of Internal Affairs and Communications 2008).

After World War II, Japan enacted special laws to give organizations different types of legal personalities: religious corporations (the Religious Corporations Act 1951), school corporations (the Private Educational Institutions Act 1949), social welfare corporations (the Social Welfare Services Act 1951), and medical corporations (Revised Medical Care Act 1949). Hatsutani (2001) emphasizes that the diversification of legal personalities was affected by the new Constitution. Article of 89 of the Constitution of Japan states that “no public money or other property shall be expended or appropriated for the use, benefit or maintenance of any religious institution or association, or for any charitable, educational or benevolent enterprises not under the control of public authority.” Just after the war, it was necessary for some types of PICs to receive public money in order to survive. One aim of the acts was to have a robust legal background for “under the control of public authority” in the Constitution.

Despite these special laws, most grassroots-level organizations in Japan had no legal status, because they lacked the level of assets that PICs require (London 1991; Deguchi 2001). The great Hanshin Awaji Earthquake in 1995 unveiled the defects of the legal system. Many volunteers were active as members of uninstitutionalized nonprofit organizations that had no legal status (Deguchi 2001; Pekkanen 2000, 2001; Kawashima 2006). In 1998, the Diet enacted a new act so that citizens’ groups could form and operate with legal personality (Deguchi 2001). The law created the Specific Nonprofit Activity Corporation (SNC), usually called NPO *hojin* (NPO corporation). The act was called the NPO law.

In 2001, yet another category of organization was created. A nonprofit and non-public benefit organization could be incorporated as *Chukan-hojin* (Intermediate Juridical Person, or IJP).

The various types of organizations are overseen by different government agencies, each with its own accounting standards and regulations: School Corporation Accounting Standard for school corporations, Social Welfare Corporation Accounting Standard for social welfare corporations, Religious Corporation Accounting Guideline for religious corporations, Medical Corporation Accounting Standard for medical corporations, and SNC Accounting Standard for SNCs.

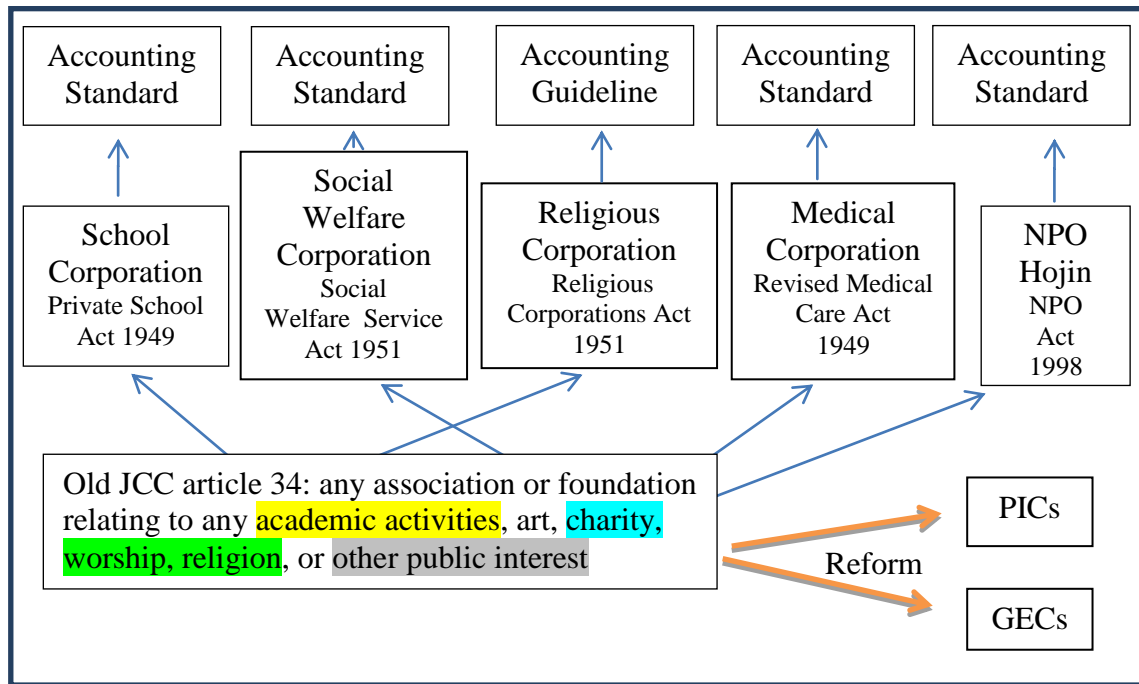
The reform of the legal framework targeted only PICs and IJPs. School Corporations, Social Welfare Corporations, Medical Corporations, Religious Corporations, and SNCs continue to exist. The complicated situation of Japan’s nonprofit organizations, as Figure 1 illustrates, might be called an example of “Galápagos Syndrome” (Deguchi 2015). Nakamura explains,

² Reflecting the Japanese legal context, this article uses the term “public interest” rather than the more common term in the academic literature, “public benefit.”

³ Sometimes referred to as Public Interest incorporated Persons (PIPs).

“Galápagos syndrome is a frequently used term in Japanese business circles to mockingly refer to technologies and specifications advancing in a form that lacks compatibility with other countries, much like how animals on the Galapagos Islands evolved uniquely in a closed environment” (Nakamura 2013: 66). Cellular phones represent one example of Galápagos Syndrome in Japan. Each company produces phone that address different consumer needs, and they are very difficult to standardize.

Figure 1: “Galápagos Syndrome” of Japan’s Nonprofit Legal Personality



Source: author’s analysis from the version written in Japanese (Deguchi 2015). *Kaikei-kijyun* is translated into Accounting Standard, and *Kaikei-jyunsoku* is translated into Accounting Guideline. Each accounting standard and guideline is different.

III. Overview of Reforms

One impetus behind the reforms was to encourage activities by the Third Sector, whose importance is recognized by the government (Expert Meeting 2004, Tax Commission 2005). The reform process began with a Cabinet Decision released as Reform of the System of Public Interest Corporations in 2002 (Cabinet Decision 2002). After a confusing start, the Tax Commission issued a report in 2005 (Tax Commission 2005) that proposed that new PICs should be tax-exempt and tax deductible.⁴

A particular problem was the *Kyoka* (permission) system for establishment of PICs (Expert Meeting 2004). Organizations seeking PIC status had trouble finding the appropriate agency and then finding the appropriate person or division within the agency, and once they succeeded in doing so, a laborious series of consultations, negotiations, and compromises would follow (London 1991). The system set no time limits and no clear criteria for agency decisions (Pekkanen 2006). Further, the public interest element of some PICs seemed questionable, such as

⁴ As a member of the Tax Commission from 2003 to 2009, the author contributed to the report.

parking lots and golf courses (London 1991). In addition, retired government officials sometimes took high-paying positions in the PICs that they had previously overseen (Kaihara 2008; Deguchi 2009).

The reform process resulted in three related PIC acts in 2006, which abolished the *Kyoka* (permission) system: first, the Act on General Incorporated Associations (GIA) and General Incorporated Foundations (GIF) (Act No. 48 of 2006); second, the Act on Authorization of Public Interest Incorporated Associations (PIIA) and Public Interest Incorporated Foundations (PIIF) (Act No. 49 of 2006); and third, the Act Concerning Special Measures for Enforcement (Act No. 50 of 2006). While the old civil code on PICs consisted of only 56 articles, these laws amount to 868 articles.

In order to authorize PICs among GIAs and GIFs, which are considered nonprofit organizations that do not always operate in the public interest, the laws established two new entities: the Public Interest Corporation Commission (PIC Commission), for national organizations; and the Council Organization Established in Prefectures (COEP), for local ones.

The PIC Commission's function resembles that of the Charity Commission in England and Wales.⁵ The PIC Commission has seven commissioners appointed by the Prime Minister with the consent of both houses of the Diet (Act. No. 49, Article 35).⁶ In operation, the Commission is independent of ministerial government. It has a staff of almost 100.⁷ Article 5 of Act No. 49 sets forth clear criteria for the Commission to apply, addressing an organization's purpose, financial operations, and governance and accountability.

In addition, the tax system underwent major positive changes. An organization approved by the PIC Commission is exempt from corporate tax and enjoys tax-deductible status, except that its for-profit businesses (which are permitted) are taxed. Under another law, donors to certified PICs can choose tax deduction or tax credit.

The reforms drew applause from stakeholders (JCIE 2005; JACO 2014).

IV. Globalization and the Shadow of the Business Sector

In 2008, the PIC Commission issued a new accounting standard: Public Interest Corporation Accounting Standard 2008 (PICAS-2008). Previous standards had been issued in 1977, 1985, and 2004. PICAS-2004 reflected the trend of "financial accounting" that spread following enactment of the Sarbanes-Oxley Act of 2002 (SOX) in the United States (Ribstein 2003; Shirley 2004). SOX influenced nonprofit organizations internationally (Stone & Ostrower 2007; Johnson 2009; Breen 2013). Although Kawashima (2006) points out that nonprofit organizations in Japan paid less attention to SOX than those in some other countries, SOX did make a substantial impact on accounting standards in Japan. One effect was felt through the Statement of Financial Accounting Standards No. 117 (FASB 1993), issued by the Financing

⁵ Commissioners do not have a free hand to change charitable purposes, as the Charity Commission is a government body and the discretion of Commissioners remains confined by established precedent (O'Halloran, McGregor-Lowndes, & Simon 2008).

⁶ The PIC Commission operates at the nationwide level. Local authorities are responsible for each council organization. Article 50 of Act. No. 49 of 2006 stipulates that council organizations shall be established in prefectures for the purpose of dealing with the matters assigned to it by this Act.

⁷ As of the end of March 2013

Accounting Standards Board in the U.S. (FASB),⁸ which emphasized fiduciary duty (On Revision of PICAS 2004). Among other things, PICAS-2004 created categories paralleling those in American tax law.

PICAS-2008 represents a hybrid of principles from the Charity Commission in England and Wales, American accounting practices, and Japanese tradition. Critics contend that it facilitates control by government rather than serving users (Tetsuyoshi Hasegawa 2012).

PICAS-2008 resulted from a process of working groups of stakeholders, which has also been used in New Zealand (Sinclair & Bolt 2013). The PIC Commission set up a research meeting with accountants and representatives from constituents. They discussed accounting standards to be applied under the new acts. The result of the discussion was a proposal submitted to the PIC Commission. Some commissioners were startled with the revision of the accounting standard (PIC Commission the 33rd Official Minutes 2008).

When the Cabinet Office opened the proposal to public comment, the influential Japan Association of Charitable Organizations said that the standards-setting body should not be the PIC Commission (JACO 2008). Similar comments came from academia (Hasegawa 2013). The Japan Institute Certified Public Accountants (JICPA) filed a petition with the PIC Commission in 2013, questioning whether Japan's Generally Accepted Accounting System should be applied to PICs, given that their missions and activities differ from those of for-profit corporations (JICPA 2013).

V. “Glocalization” of Standards

Tatsuo Ohta, a representative of the Japan Association of Charitable Organizations, said that the reforms were based on “free, fair and global” points (Ohta 2006, JACO 2014a), reflecting the fact that legislation, tax, and accounting all are moving toward global standards (JACO 2014a: 15).

Although globalization is an influence, as Ohta pointed out, the reforms continue to reflect particularization. PICAS-2008 applies only in Japan, for example. So do specific PIC accounting rules and regulations. Accordingly, experts in nonprofit entities of other types from other countries will not be familiar with the Japanese rules. In this respect, the PIC reforms simply extend Galápagos Syndrome.

Related to Galápagos Syndrome is what has been called the “glocalization” of the nonprofit system. Glocalization is a Japanese term that, in a journalistic context, reflects the notion of thinking globally and acting locally (Sudo 2012). The concept has been further developed by academics (Robertson 1995; Maekawa 2004; Sudo 2012; Fukukawa & Teramoto 2009). Generally, the term means that local cultures and the forces of globalization interpenetrate and interpret each other, resulting in both universalizing and particularizing tendencies (Thompson & Arsel 2004; Fukukawa & Teramoto 2009). Even the law shows glocalization (Randeria 2003). PICAS-2008 is an example.

At the same time, though, globalization is having a substantial effect on rules that apply to the for-profit sector (Kikuya, M. 2001). The legal reform of governance of business companies in Japan is influenced by global trends (Okabe 2009). In a sense, Japanese rules for

⁸ See Kaneko 2009 (in Japanese).

the nonprofit sector are not under the direct sway of globalization, but they are undergoing globalization through the for-profit sector.

VI. Conclusion: Complication, Regulation, and Globalization

Have the reforms succeeded? They can be evaluated in terms of the major purposes underlying them. Three purposes are particularly significant.

One purpose is to strengthen PIC self-governance. Here, the system has fallen short. It is difficult for many PICs to understand. With three acts, the new accounting standard, and new acronyms and jargon, even government officials have had trouble.

Especially for small PICs, further, the requirements are an overload (JACO 2014). Except for the requirement of an accounting auditor, the same rules apply to small and large PICs. Many PIC are small. In 2014, the median staff size was just five, and a third of PICs had two or fewer full-time staff members (Cabinet Office 2014c). In addition, Japan has few PIC experts. Experts in law and accounting typically focus on for-profit businesses. Nonprofit systems are different—at least, they should be.

A second purpose of the reform is “implementing such programs in a suitable manner” (Article 1 of APPI)—imposing the face of the regulator. With the PIC Commission, the reform succeeded in this regard.

Unfortunately, the regulator has not always helped fulfill a third purpose of the reform: to change unclear rules into clear ones. For example, the PIC Commission issued a statutory recommendation to a sports organization in 2014.⁹ The organization had set up a third-party committee to investigate an internal scandal and issue a report to their legal members and the administrative agency. These steps followed the PIC rulebook, but the PIC Commission was dissatisfied. It explained that “because the ultimate stakeholder is all Japan’s citizen as the taxpayers,” reporting to legal members and the cabinet office was insufficient. Instead, “according to the guideline of the Japan Federation of Bar Associations, the report by the third-party committee of a public-listed company should be open to the public” (Cabinet Office “Kankoku” 2014).

This is a typical example. Even if an organization masters all 868 articles of the new laws, the Cabinet Order, the Cabinet Office Ordinance, the new financial standard, and the PIC guidelines, the government may still step in and impose the standards of large for-profit companies on small PICs. In this respect, globalization seems to be prevailing over glocalization and Galápagos Syndrome.

The current problems of Japanese society are serious, and tax funds alone cannot solve them. The role of the PIC Commission should be to ensure that PICs perform flexibly in addressing social problems that the government cannot resolve, rather than imposing unnecessary restrictions on them.

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⁹ The author had left the Commission by that point.

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Not-for-Profit Law and Culture in Asia

CHARITY LAW REFORM IN HONG KONG: TAMING THE ASIAN DRAGON?

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The number of charitable organizations in Hong Kong has increased significantly despite unclear and lax regulation. A legislator has identified flaws in the present law and recommended changes. The proposed recommendations, however, do not consider the unique characteristics of Hong Kong. If implemented, they would not address the existing problems adequately. In order to tame the Asian Dragon, this article proposes an alternative model: self-regulation, which relies on the work of charity watchdogs.

I. Introduction

“The great personal freedom granted modern men has meant that one can be free and rich, or free and just getting by, or free and poor or destitute—and with no master to fall back on.”¹

The charitable landscape in Hong Kong, formally known as the Hong Kong Special Administrative Region, is unique. The Hong Kong people feel a responsibility toward their communities based on traditional Chinese thoughts and perceptions. In 2012, almost US\$1.3 billion (HK\$10 billion) was donated by the local people, with the largest donation amounting to US\$257 million (around HK\$1.9 billion). If the numbers are to be trusted, the charitable landscape is remarkably vibrant.

However, charitable organizations act in a legal vacuum, without clear regulation. In recognition of the problem, the Law Reform Commission of Hong Kong initiated a review of charity law in September 2007. It recently published its comprehensive review, including eighteen generally modest recommendations. While some have criticized the reform package for not going far enough, its shortcomings are actually more fundamental.

This article explores the ongoing charity law reform in Hong Kong. It examines the historical development of charitable organizations, reviews the charity law reform, and argues that the current proposals fail to address the interests involved. The article suggests a more flexible yet robust solution, one that is closer to market needs: reliance on independent charity watchdogs.

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¹ Whalen Lai, *Chinese Buddhist and Christian Charities: A Comparative History*, *Buddhist-Christian Studies*, 12 (1992), 29.

II. The Charitable Sector in Hong Kong

In 2014, 8,044 charitable organizations were registered with the Internal Revenue Department (IRD).² The figure was 7,592 in 2013, 7,194 in 2012, and 6,788 in 2011, marking a continuous growth of charitable organizations.³ The amount of donations has increased as well. It was almost US\$1.3 billion (HK\$10 billion) in the tax years of 2011-2012 and 2010-2011, and more than US\$1.03 billion (HK\$8 billion) in 2009-2010.⁴ Remarkably, donations did not decrease after the SARS outbreak in 2003 and the financial crisis in 2008.

These numbers were supported by a surge in super-donations worth more than one million U.S. dollars. The brothers Ronnie and Gerald Chan donated US\$175 million (HK\$1.3 billion) each to Harvard University.⁵ Gordon Wu gave US\$100 million (HK\$775 million) to Princeton University,⁶ and Robert Ho donated US\$25 million (HK\$193 million) to his alma mater, Colgate University.⁷ According to a study, 104 donations worth more than US\$1 million each were made by 47 donors in 2012—including one donation worth more than US\$257 million⁸—for a total of US\$877 million (around HK\$6.8 billion). Most “super-donors” gave around US\$1.3 million, an amount that is “not surprising given that it’s worth around HK\$10m – a natural threshold for high-net-worth giving in Hong Kong.”⁹ Some donors also made several US\$1 million donations in 2012. The Hong Kong Jockey Club Charities Trust, for example, made 36 such donations.¹⁰ Donations made by individuals were significantly larger than donations made by foundations such as the Hong Kong Jockey Club Charities Trust.

² Inland Revenue Department, Annual Report 2013-14, 46, http://www.ird.gov.hk/eng/ppr/are13_14.htm.

³ Inland Revenue Department, Annual Report 2012-13, 49, http://www.ird.gov.hk/eng/ppr/are12_13.htm; Annual Report 2011-12, 45, <http://www.ird.gov.hk/dar/2011-12/table/eng/misc.pdf>; Annual Report 2009-10, 49, http://www.ird.gov.hk/dar/2010_11/table/eng/others.pdf. Cf. http://www.hkcss.org.hk/e/cont_detail.asp?type_id=11&content_id=862.

⁴ Inland Revenue Department, Annual Report 2012-13, 49. Cf. iDonate, Analysis of Donation Trend in Past Five Years (2011), http://www.theidonate.com/media/report_file/iDonate-Analysis-201106_1.pdf; Hong Kong Council of Social Service, The Rise of the Middle-Class Donor, http://www.hkcss.org.hk/e/cont_detail.asp?type_id=11&content_id=862; Hong Kong Council of Social Service, Charitable Donations Allowed Under Profits Tax and Salaries Tax, http://www.hkcss.org.hk/e/cont_detail.asp?type_id=11&content_id=801.

⁵ South China Morning Post, *Hong Kong tycoons’ US\$350m Harvard gifts among world’s top charity donations of the year*, Dec. 10, 2014, <http://www.scmp.com/news/hong-kong/article/1659362/hong-kong-philanthropists-harvard-gifts-top-10-charitable-donations?page=all>.

⁶ Giving to Princeton, *Princeton Celebrates Sir Gordon Wu’s Extraordinary Support*, May 1, 2007, <http://giving.princeton.edu/news/2007/05/princeton-celebrates-sir-gordon-wus-extraordinary-support>.

⁷ Colgate, *Colgate’s most generous “investor,”* March 2004, <http://www4.colgate.edu/scene/mar2004/ho.html>.

⁸ The donation was made by Dr. Tin Ka Ping, founder of Tins Chemical Limited and Tin Ka Ping Foundation. South China Morning Post, *Charity begins at home for city’s HK\$7b top philanthropists*, Nov. 21, 2013, <http://www.scmp.com/news/hong-kong/article/1362360/charity-begins-home-citys-hk7b-top-philanthropists>. Cf. Coutts, *The Million Dollar Donors Reports 2013*, 17, <http://philanthropy.coutts.com/en/reports/2013/executive-summary.html>; Coutts, *The Million Dollar Donors Reports 2014*, <http://philanthropy.coutts.com/en/reports/2014/executive-summary.html>.

⁹ Coutts, *Million Dollar Donations 2013*, 18.

¹⁰ *Id.*, 17.

For three reasons, these numbers understate the actual situation. First, the figures for the number of charitable organizations only cover organizations registered with the IRD, whereas some charitable organizations are under no registration obligation. Second, because of cultural and legal factors, not all donations are disclosed. Chinese donors often keep a low profile and prefer to stay anonymous.¹¹ Finally, the official figures provided by the IRD account for donations for which tax deduction was made. However, the low-tax system of Hong Kong provides limited incentives for such super-donations, so some donors do not deduct them from taxes.

*“Private philanthropy in Hong Kong has both the virtues and the flaws of the family-controlled companies whose earnings have created the wealth that translates into generosity, often on a grand scale.”*¹²

A charitable landscape is shaped by the people who donate not only money but also time. These people make a charitable sector dynamic and active. There is a long line-up of events in Hong Kong throughout the year that raise funds for charitable causes.¹³ Local universities motivate students to engage in charitable activities and incorporate such activities into the curriculum.¹⁴ Organizations run community involvement programs to encourage citizens to help one another.¹⁵

Beyond the classical concept of charity focused on donations, a new form of charity focused on doing good has emerged. Indeed, new ways are sought to combine entrepreneurial skills with a charitable purpose, known as social venture or social enterprise.¹⁶ Under the paradigm of “make money and do good,” socially conscious entrepreneurs build businesses to drive change. Charitable organizations, for example, open cafes employing people with different abilities.¹⁷ The most famous example of a local social venture is probably Dialogue in the Dark Hong Kong, which operates as a global franchise business and attempts to empower and change perceptions toward people with visual impairments.¹⁸ By contrast to classical charities, such organizations generate money themselves and do not rely only on donations. Recognizing their potential, the government now attempts to support social ventures through different programs.¹⁹ Social ventures are more than a mere trend in Hong Kong. They represent a shift in the understanding of how social problems are best solved.

The principle that making money and creating social impact ought to go together is to be welcomed. However, charitable organizations with an entrepreneurial approach raise unique issues. The Li Kai Shing Foundation is an example of a charitable organization that executes

¹¹ Id., 6.

¹² South China Morning Post, *Spirit of Giving*, Dec. 23, 2005, <http://www.scmp.com/node/530396>.

¹³ E.g., Hong Kong Standard Chartered Marathon, Operation Santa Claus.

¹⁴ E.g., OSC Inter-School MBA Charity Challenge, CUHK I Care Programme.

¹⁵ Swire, Sustainable Development, http://www.swire.com/mt/en/about_swire/subsustainable_development.

¹⁶ Damian Bethke, Jędrzej Górski, *Rethinking Social Ventures in Hong Kong*, RJGLB 13 (2014), 1.

¹⁷ E.g., Cafe 8, opened by the Nesbitt Centre. See <http://www.nesbittcentre.org.hk/index.php/the-coffee-shops/cafe-8>.

¹⁸ <http://www.dialogue-experience.com.hk/web/index.php?lang=en&mid=0>.

¹⁹ Bethke, Górski, *Rethinking Social Ventures in Hong Kong*, 13.

strategic investment choices. It acquired a 0.8% stake in social networking website Facebook for US\$60 million and invested in the music streaming service Spotify.²⁰ Such investments are not as such to be criticized, but the absence of transparency and clear-cut definitions can be problematic. As the law now stands, a charitable organization could be easily abused as a shield against tax obligations.

III. Origins of Charitable Giving

A. Early Roots

The idea of giving is deeply rooted in Chinese culture.²¹ Early altruism was based on religious thoughts and practices of Chinese custom.²² With the influence of Western traditions during the British colonial period in Hong Kong, particularly British common law, the Chinese form of altruism was legally institutionalized in the concept of charity. However, charitable giving remains fundamentally inspired by the distinctive Chinese attitude.

The Asian notion of charity has strong foundations in Buddhism, Confucianism, Taoism, and folk culture.²³ Confucianism regarded philanthropy as one of the fundamental constituents of nobleness and superiority of character and as a virtue natural to all persons.²⁴ Buddhist monks followed a set of monastic precepts which required them to care for the sick.²⁵ Accordingly, Buddhist monasteries provided social services such as building schools, hospitals, and orphanages, and helping the victims of famines.²⁶ Buddhist schools and hospitals were known for being “wards for nursing the sick [of] the merit field of compassion.”²⁷ But even though the hospitals were open to the public, services were provided only within their gates.²⁸ Buddhist monasteries enjoyed tax exemption as well as strong financial support from the public.²⁹ Donors

²⁰ Reuters, *Li Ka-shing Foundation buys Facebook stake*, Dec. 3, 2007, <http://www.reuters.com/article/2007/12/04/us-facebook-likashing-idUSN0344520920071204>; Forbes, *Li Ka-shing Confirms Spotify Stake*, Aug. 20, 2009, <http://www.forbes.com/2009/08/20/spotify-li-hutchison-markets-equities-technology.html>.

²¹ Cf. Yu Yue Tsu, *The Spirit of Chinese Philanthropy* (1912).

²² *Id.*

²³ *Id.*, 16.

²⁴ *Id.* “The feeling of commiseration belongs to all men; so does that of shame and dislike; and that of reverence and respect; and that of approving and disapproving. The feeling of commiseration implies the principle of benevolence; that of dislike and shame; the principle of righteousness; that of reverence and respect, the principle of propriety; and that of approving and of disapproving, the principle of knowledge. Benevolence, righteousness, propriety and knowledge, are not infused into us from without. We are certainly furnished with them. Hence it is said ‘Seek and you will find them. Neglect and you will lose them.’ Men differ from one another in regard to them; some as much again as others, some five times as much, and some to an incalculable amount: it is because they cannot fully their natural powers.” Mencius, in Yu Yue Tsu, *Spirit of Chinese Philanthropy*, 17.

²⁵ Peter Harvey, *An Introduction to Buddhist Ethics* (2000), 147.

²⁶ Keulman Kenneth, *Critical Moments in Religious History* (1993), 64; Whalen, *Chinese Buddhist and Christian Charities*, 9.

²⁷ Whalen, *Chinese Buddhist and Christian Charities*, 10.

²⁸ *Id.*, 11.

²⁹ Yongshan He, *Buddhism in the Economic History of China: Land, Taxes and Monasteries*, Master Thesis, 2011, 31, <http://digitalcommons.mcmaster.ca/cgi/viewcontent.cgi?article=7442&context=opendissertations>.

did not see this as a mere act of giving; they believed in a principle of reciprocity.³⁰ Donations were seen as a chance for laymen to accrue merit by emulating monks' freedom from material concerns.³¹ Gifts were made for a specific purpose, and monks could not use them for something else.³² Donors' wills were respected.

Monasteries later experienced a decline and were taken over by civil authorities;³³ "the state charities competed with and undercut the Buddhist charities."³⁴ Nonetheless, the idea of charity persisted and influenced other institutions, such as mutual aid associations, members' associations, trade guilds, and clans, which were based on a similar idea of mutual benefit.³⁵ Members of an association would more readily help members of the same association than members of other associations.³⁶ Clan organizations sometimes had clan charities, handed down from their ancestors, which might distribute grain to their members.³⁷ Poor families were also supported with loans provided by mutual loan societies.³⁸ People organized civic associations, such as clansman associations, and supported one another.³⁹ The center of the culture, in their view, was not the individual but the family, community, or clan.⁴⁰

The principle of mutuality was the main motivation behind charitable giving and had the function of insurance. It guaranteed that the community would help anyone who had previously helped others.⁴¹ This idea of *do ut des* is similarly expressed in the principle of *guangxi*, which held that help must be provided to people with whom one had a personal relation.⁴² If such ties were absent, Chinese people would not feel an obligation to help.⁴³

Besides the idea of mutuality as a basis of charitable giving, China also had experience with do-good or benevolence associations, which provided help to anybody in need and not solely within the ambit of members. Benevolence associations were established on the belief that

³⁰ Whalen, *Chinese Buddhist and Christian Charities*, 8, 11. This was similar in Europe, where a beggar would say, "Bless ye, sire."

³¹ *Id.*

³² *Id.*, 8.

³³ *Id.*, 13.

³⁴ *Id.*, 12.

³⁵ Elizabeth Sinn, *Power and Charity, A Chinese Merchant Elite in Colonial Hong Kong* (2003), 13; cf. Henry James Lethbridge, *The Evolution of a Chinese Voluntary Association in Hong Kong: The Po Leung Kuk*, *Journal of Oriental Studies*, 10 (1972); Thomas Menkhoff, Hoon Chang-Yau, *Chinese Philanthropy in Asia Between Continuity and Change*, *Journal of Asian Business*, 24 (2010), 2; John Kerr, *Native Benevolent Institutions of Canton*, *China Review* (1873), 88.

³⁶ Yu Yue Tsu, *Spirit of Chinese Philanthropy*, 75.

³⁷ *Id.*, 78.

³⁸ *Id.*, 85.

³⁹ *Id.*, 75.

⁴⁰ Ho Andrew, *Asian-American Philanthropy: Expanding Knowledge, Increasing Possibilities*, Working Paper No. 4 Georgetown University, Center for Public & Nonprofit Leadership (2004), presented at the ARNOVA Annual Conference, Los Angeles, California, 2, <http://issuu.com/andyho/docs/asianamerican>.

⁴¹ Yu Yue Tsu, *Spirit of Chinese Philanthropy*, 75.

⁴² Ho, *Asian-American Philanthropy*, 5.

⁴³ *Id.*

doing “good is a joy.”⁴⁴ Being engaged in such an association was seen as a status symbol, and the local elite, merchants, and other notables were involved in them.⁴⁵ Religious beliefs were unimportant in these associations, and they were not based on a principle of mutuality.⁴⁶ They were run “by the better off for the less well off.”⁴⁷ Nonetheless, the help provided was still morally colored, and it was usually confined to widows, widowers, orphans, and others without families.⁴⁸

In a nutshell, the original form of Chinese philanthropy was based on the idea of mutuality or reciprocity. Making donations was a cultural requisite that grew out of a cultural obligation to help one’s community. A deep-rooted sense of obligation towards the community is an important motivation for charitable giving.

These aspects can still be identified in modern donors’ behavior. People in Hong Kong donate because they feel a sense of obligation to help the underprivileged and because making donations allows them to appreciate their wellbeing and fortune. Ignoring communal problems would isolate them and prevent them from receiving support if they were ever themselves in distress. And with many of the Hong Kong people still strongly connected with families and communities living in the mainland of the People’s Republic of China (Mainland), donors often prefer to contribute to projects that focus on the Mainland.⁴⁹

B. Development of Charitable Organizations in Hong Kong

Modern charity law in Hong Kong has been deeply influenced by the social and economic policy of the British government toward Hong Kong. This influence resulted in a symbiosis of foreign elements with Hong Kong characteristics.⁵⁰ A look into the historical development of charitable organizations is helpful to explore this relationship.

The colonial government adhered to a policy of maintaining a distance from the Chinese people of Hong Kong. While foreigners enjoyed all the amenities of the colonial rule, the Chinese people were excluded. Rather than aiding the Chinese, foreigners urged them to find means of self-help. Ever since, the Chinese have organized themselves in associations such as trade and craft guilds.⁵¹ But the British rule also witnessed a growth in secret societies that pursued criminal activities such as robbery, smuggling, or piracy.⁵² Although the powerful locals involved in such societies sometimes carried out criminal activities, they also had an important

⁴⁴ Whalen, *Chinese Buddhist and Christian Charities*, 21.

⁴⁵ *Id.*, 23.

⁴⁶ *Id.*, 22.

⁴⁷ *Id.*, 23.

⁴⁸ *Id.*, 22; see also Yu Yue Tsu, *Spirit of Chinese Philanthropy*, 43.

⁴⁹ See e.g. the projects funded by the Li Ka Shing Foundation, <http://www.lksf.org>.

⁵⁰ Wai-Fung Lam and James L. Perry, *The Role of the Nonprofit Sector in Hong Kong’s Development*, *International Journal of Voluntary and Nonprofit Organizations*, 11 (2000), 364, 356-362. For an analysis of the reasons leading to a rise of charitable organizations in general, see Lester M. Salamon, *The Rise of the Nonprofit Sector*, *Foreign Affairs*, 73 (1994) 109, 115.

⁵¹ Sinn, *Power and Charity*, 13.

⁵² *Id.*

stabilizing function. They engaged with their communities by providing support.⁵³ For example, the secret societies known as *kaifong* associations, meaning neighborhood associations, provided social services neglected by the colonial government.⁵⁴

“Colonial ignorance, indifference, and incompetence created a demand for services that these merchants were in a special position to offer. Through charitable and voluntary organizations, they resolved civil and commercial disputes, provided medical facilities, and created a voice for the Chinese community. By offering such services, local Chinese merchants were able to take advantage of Hong Kong’s position at the edge of the Chinese and British empires to enhance their own power and prestige.”⁵⁵

The colonial government adhered to a social policy of separation, and social aid was kept to a bare minimum. With power centralized and vested in the colonial government, a bridge was struck between popular consent building and strong colonial rule.⁵⁶ The provision of social services was not on the agenda of the government.⁵⁷ Welfare services played a minor role in colonial Hong Kong from 1880s to 1950s.⁵⁸ Welfare services were generally rendered only when they served the interests of the government, such as the education of personnel needed for the administration.⁵⁹ The financial policy overall was conservative; it sought to avoid budget deficits.⁶⁰ In brief, charitable activities were not on the minds of government officials.

The earliest exception to this policy of non-intervention was the establishment of the Tung Wah Hospital in 1872, the first institution in Hong Kong that provided free medical treatment to local Chinese people in need.⁶¹ The government initiated the hospital because it was concerned about the sick and destitute. Wealthy locals financed the hospital,⁶² and influential residents, successful businessmen, and leaders of *kaifong* organizations managed it.⁶³

The next institution set up for the benefit of the underprivileged was the Po Leung Kuk, established in 1878. To stop kidnappers from bringing children and women into Hong Kong,

⁵³ Id., 16.

⁵⁴ Cf. for more details Aline K. Wong, *Chinese Voluntary Associations in Southeast Asian Cities and the Kaifongs in Hong Kong*, Journal of Royal Asiatic Society Hong Kong Branch, 11 (1971), 62.

⁵⁵ John M. Carroll, *Edge of Empires: Chinese Elites and British Colonials in Hong Kong*, Harvard University Press, 2005, 60.

⁵⁶ Lam, Perry, *The Role of the Nonprofit Sector in Hong Kong’s Development*, 363. Cf. id., 356: “The government could be described as an executive-led and centralized political-administrative system which did not intervene into matters which would have posed a departure of its traditional role best described as ‘positive non-interventionism.’”

⁵⁷ Id., 366

⁵⁸ Elyza W.Y. Lee, *Nonprofit Development in Hong Kong: The Case of a Statist-Corporatist Regime*, Voluntas: International Journal of Voluntary and Nonprofit Organizations, 16 (2005), 55.

⁵⁹ Id., 55.

⁶⁰ Id. Cf. Elyza W.Y. Lee, *The Politics of Welfare Developmentalism in Hong Kong*, Social Policy and Development Programme Paper, 21 (2005), ³.

⁶¹ Carroll, *Edge of Empires*, ⁶¹.

⁶² Id., 37.

⁶³ For more information see Carl T. Smith, *Chinese Christians, Elites, Middlemen and the Church in Hong Kong*, Hong Kong University Press, 2005, 124.

influential Europeans and wealthy Chinese founded the institution as a refuge for people who would otherwise be socially marginalized.⁶⁴

The Tung Wah Hospital and the Po Leung Kuk were new types of institutions in Hong Kong. Although hospitals had been operated by Buddhist monasteries for hundreds of years, they were not public and did not provide any services outside the gates of the monasteries. These two institutions provided shelter and services to members of the general public regardless of their religion or communal group. This marked the introduction of a new concept of social responsibility.

There seems to be a connection between the arrival of Christian missionaries and the establishment of the next charitable organizations in Hong Kong. These organizations resembled Western institutions established for the poor and operated by churches.⁶⁵ The Young Men's Christian Association (YMCA) was set up in 1918 to provide community services to the public, to organize camps, and to provide children with education.⁶⁶ It was the first gymnasium with an indoor swimming pool, restaurant, and dormitory, which was new to the Chinese people in Hong Kong. Unlike earlier organizations such as the benevolence associations, the YMCA did not exclusively operate on a Christian mission; it also helped people of other beliefs. Local people appreciated the support and considered the institution a success. The YMCA served as an example for other international organizations,⁶⁷ and the Red Cross and the Salvation Army launched similar efforts in Hong Kong.⁶⁸ The colonial government trusted these organizations and relied on them to support the underprivileged and to educate the children of colonial officials.⁶⁹ Further, the government found it convenient to contract out more and more educational services to the church.⁷⁰ The Christian anticommunist Christian religion was regarded as an ideological protection against the influence of the Chinese Communist Party.⁷¹

The next level of evolution was reached when the government established the Hong Kong Council of Social Service (HKCSS) in 1947. Recognizing that more needed to be done about the underprivileged, the government adopted a policy described as "big bang."⁷² The HKCSS was founded as a result of increased need after World War II. Its purpose was planning

⁶⁴ Lethbridge, *The Evolution of a Chinese Voluntary Association in Hong Kong*, 33. Cf. id., 39: "The undersigned merchants, engaged here in trade for many years past, have lately noticed that the crimes of kidnapping are increasing from day to day. Many of both the kidnappers and of their kidnapped victims are natives of our native district (Tung-kun). Seeing this to be the state of affairs, it is unbearable to think that these villains take this hospitable Colony for a convenient refuge. A meeting has therefore been held and it is proposed to raise subscriptions with the view to publish everywhere offers of reward."

⁶⁵ E.g. the Hospital of St. Wulstan established around 1085, the hospital of St. Oswald established around 1268, and the hospital of St. Cross established around 1132.

⁶⁶ Whalen, *Chinese Buddhist and Christian Charities*, 29.

⁶⁷ Terence Yiu Kai Yuen, *Hong Kong*, Asia Pacific Philanthropy Consortium Conference, September 5-7, 2003, 91; Lee, *Nonprofit Development in Hong Kong*, 58.

⁶⁸ Lee, *Nonprofit Development in Hong Kong*, 58.

⁶⁹ Id.

⁷⁰ Id.

⁷¹ Lee, *The Politics of Welfare Developmentalism in Hong Kong*, 2.

⁷² Tang Leung Kwong, *Colonial State and Social Policy: Social Welfare Development in Hong Kong, 1842-1997*, University Press of America, 1998, 61.

and coordinating the welfare services and relief that various organizations provided.⁷³ The HKCSS is still a fundamental structure in the charitable landscape in Hong Kong because it is the bridge between the government and the non-profit sector. It began as a facilitator but gradually took on a more comprehensive role.⁷⁴ The HKCSS focuses on quality management and efficiency enhancement of its partners. It provides training for, among others, fundraising and management, and it publishes guidelines for people involved in charitable organizations. The HKCSS is funded through WiseGiving,⁷⁵ its own development fund, and government subventions and grants, such as the Lump Sum Grant system of the Social Welfare Department, the Lotteries Fund, and the Community Chest.⁷⁶

During the turbulences in Hong Kong culminating in social unrest during 1966 and 1967, the government further intensified its social policy.⁷⁷ It invested in education, public housing, and social service. The people of Hong Kong entered into a social pact which combined economic individualism with social interventionism, described as a system of economic freedom in combination with an adequate social safety net.⁷⁸ With the political transition in 1997, the government commenced to spend more on social welfare in order to enhance its legitimacy.⁷⁹ This new approach was aptly labeled the “Confucian welfare state,” and it is regularly referred to as such.⁸⁰

Although Hong Kong is generally not regarded as a welfare state but rather as neoliberal,⁸¹ its social policy shows a peculiar feature. Charitable organizations fulfill a broad range of essential functions not carried out by the government. The government is not only the regulator but also the financier of charitable services.⁸² More and more tasks are left to the private sector. This may explain the boom in the number of charitable organizations. In 2013-2014, over 90 percent of social services were offered to the public through 419 not-profit organizations (NPOs), of which 33 percent (138) were subsidized by the government Social Welfare Department (SWD) and 67 percent (281) were not.⁸³ At the same time, however, subvention to NPOs was capped, which required the organizations to do more fundraising

⁷³ Chung Woon Fan Flora, *The Role of The Hong Kong Council of Social Service in Social Welfare Development in Hong Kong*, Dissertation, 30 June 2008.

⁷⁴ *Id.*, 10.

⁷⁵ WiseGiving also provides consultancy services to the third sector. The profits generated through this work are channeled to the HKCSS.

⁷⁶ HKCSS, Annual Report 2012-13, 40, http://www.hkcass.org.hk/uploadFileMgnt/0_20131113142639.pdf.

⁷⁷ Lee, *Nonprofit Development in Hong Kong*, 61.

⁷⁸ Lee, *The Politics of Welfare Developmentalism in Hong Kong*, 5.

⁷⁹ *Id.*, 6.

⁸⁰ Gordon White and Roger Goodman, *Welfare Orientalism and the Search for an East Asian Welfare Model*, in: *The East Asian Welfare Model: Welfare Orientalism and the State*, edited by Roger Goodman, Gordon White, and Huck-ju Kwon, Routledge, 1998, 13.

⁸¹ Lee, *The Politics of Welfare Developmentalism in Hong Kong*, 10.

⁸² *Id.*, 1.

⁸³ HKCSS, Annual Report 2013-14, 41, http://www.hkcass.org.hk/uploadFileMgnt/0_2014115102852.pdf. Furthermore, it is crucial to note that not all NPOs operate as charitable organizations, which may distort the market because different set of rules apply to charitable organizations and for-profit entities. This problem has been explored by Bethke, Górski, *Rethinking Social Ventures in Hong Kong*, 13.

activities.⁸⁴ Under this status quo, NPOs compete with the business sector for new services.⁸⁵ The bidding process is nontransparent, and it may raise suspicion about whether some bidders are favored.⁸⁶ Some NPOs rely heavily on subsidized projects for income,⁸⁷ which poses a risk to their independence from the government.⁸⁸ It is questionable whether this system addresses social problems in the most effective way.

The rise of charitable organizations happened without a broad legal framework. Section 3 of the Ordinance No. 3 of 1870 incorporating the Tung Wah Hospital, for example, provided, “The Corporation is erected for the purpose of establishing and maintaining a public free hospital for the treatment of the indigent sick among the Chinese population, to be supported by voluntary contributions and governed by a Board of Directors, etc.” The terminology of charitable or tax-exempt organization was not available at that time. Instead, the ordinance used the loose term of “eleemosynary corporation.” The Po Leung Kuk Incorporation Ordinance Cap. 306 of 1893 also did not make reference to any kind of charity or tax-exempt organization. This may seem surprising because the notion of “charitable uses” as defined in the statute of Elizabeth of 1601 was already established before the adoption of these ordinances. Interestingly, however, such specific provisions allowing for deductions of donations were also not needed, because Hong Kong had no income tax until 1940.⁸⁹

The first law applicable to charitable organizations as a category was enacted only in 1950 with the introduction of the Inland Revenue Ordinance (section 88).⁹⁰ The notion of charitable organization was introduced in Hong Kong through tax law because “it was not thought desirable to impose tax on institutions of a charitable, ecclesiastical or educational nature.”⁹¹ The IRO of 1950 kick-started the modern form of charitable organization. As of May 1, 2014, there were 8,044 registered charitable organizations in Hong Kong.

This proliferation of charitable organizations received an essential impetus from the Asian Financial Crisis in 1998, which tumbled the economy into a recession, with widespread unemployment, a decline in wages, and deflation of assets.⁹² As the government cut back on welfare expenses, it introduced a series of tools further supporting the local charitable sector. First, the government introduced the Service Performance Monitoring System (SPMS), a

⁸⁴ Id.

⁸⁵ Id.

⁸⁶ Id., 74.

⁸⁷ Id.

⁸⁸ This was also one of the concerns mentioned by interviewees of an extensive study conducted in Hong Kong: Charles Chan, Chapter 1, Education and Research, Study on the Third Sector Landscape in Hong Kong, 24, http://www.cpu.gov.hk/doc/en/research_reports/3rd_content.pdf.

⁸⁹ For more information see, Halsbury’s Laws of Hong Kong, 2nd ed., Cap 112, Inland Revenue Ordinance, Butterworths, 2001. Cf. Michael Littlewood, *The Hong Kong Tax System: Its History, Its Future and the Lessons It Holds for the Rest of the World*, Hong Kong Law Journal, 40 (2010). The enactment history is No. 13 of 1940 War Revenue Ordinance; No. 21 of 1940 War Revenue Amendment Ordinance; No. 29 of 1940 War Revenue (No. 2) Amendment Ordinance; No. 13 of 1941 War Revenue Ordinance; No. 20 of 1947 Inland Revenue Ordinance.

⁹⁰ Halsbury’s Laws of Hong Kong, Cap 112, 1.

⁹¹ Hong Kong Hansard, 12th January 1949, 14.

⁹² Lee, *The Politics of Welfare Developmentalism in Hong Kong*, 7.

mechanism that aims at assessing the efficiency of the provision of social services. Second, the government adopted the Lump Sum Grant System as a new funding mechanism for NPOs. And third, the government introduced a competitive bidding process to procure service contracts.⁹³ These measures boosted the nonprofit sector but made it also more dependent on state involvement – “thus, increasingly, the nonprofit sector has become an extension of bureaucracy.”⁹⁴

C. The Charity Law Reform

The charity law reform was initiated in 2007, when the Chief Justice and the Secretary for Justice asked the Law Reform Commission “to review the law and regulatory framework relating to charities in Hong Kong and to make such recommendations for reform as may be considered appropriate.”⁹⁵ A subcommittee established in September 2007 put forward a consultation paper in 2010 and solicited public make comments on the local charity law.⁹⁶ A total of 264 comments were submitted. The Law Reform Commission published its report on the consultation process in December 2013. This report provided a comprehensive review of local charity law and recommendations for improvement. These recommendations are generally modest, because the most contentious proposal—to establish a centralized regulatory and supervisory authority in the form of a charity commission—was eventually abandoned. The report offers a practical analysis with few new insights. A number of aspects were ignored. Accordingly, the recommendations are likely to have little impact if they are implemented.

The reform has been driven by concerns about the existing law, particularly its lack of a statutory definition of charity, a system of oversight, a uniform and concise statute applying to charitable organizations, and a legal requirement for the disclosure of annual reports. Luckily, Hong Kong has yet not been affected by scandals, but the weak regulatory basis gives rise to concern.

Other issues also helped drive the push for a review of charity law. International trends played a role—specifically, the war on terror and the fear that terrorist organizations may use charitable organizations to launder money.⁹⁷ Further, the local reform process coincides with general reviews of the charity law in other common law jurisdictions.⁹⁸ This certainly influenced the outcome of the reform, because the law of the other jurisdictions was closely examined through the published reports. Some of the examined jurisdictions, such as Ireland, have

⁹³ Lee, *Nonprofit Development in Hong Kong*, 64.

⁹⁴ Yuen, *Hong Kong*, 91.

⁹⁵ The Law Reform Commission of Hong Kong, Charities Sub-Committee, Consultation Paper, Charities, June 2011, 2, <http://www.hkreform.gov.hk/en/publications/charities.htm>.

⁹⁶ Id.

⁹⁷ Kerry O’Halloran, Government – Charity Boundaries, in *Modernising Charity Law: Recent Developments and Future Directions*, edited by Myles McGregor-Lowndes and Kerry O’Halloran, Edward Elgar Publishing, 2010, 168. This happened in Ireland: cf. e.g. Oonagh B. Breen, Ireland Pemsel Plus, in *Modernising Charity Law: Recent Developments and Future Directions*, edited by Myles McGregor-Lowndes and Kerry O’Halloran, Edward Elgar Publishing, 2010, 74.

⁹⁸ For an overview cf. e.g. Kerry O’Halloran, Bob Wyatt, Laird Hunter, et al., *Charity Law Reforms: Overview of Progress Since 200*, in *Modernising Charity Law*, 13.

themselves reformed their legislation amid fears that the laws had loopholes for terrorist organizations to exploit.⁹⁹

But the principal motivation for the reform is a perceived lack of transparency of charitable organizations and resultant mistrust.¹⁰⁰ A review showed that 90 percent of the public regards the issue of transparency the dominant factor when making a decision to donate.¹⁰¹ Criticism has also come from the media.¹⁰²

The recommendations made by the Law Reform Commission attempt to enhance transparency by statutory provisions and voluntary codes of conduct. The following section of this article examines perceived holes in the charity law and the charity law reform's attempts to address them.

D. Perceived Holes in the Law

*"I am unable to find any principle which will guide one easily, and safely, through the tangle of the cases as to what is and what is not a charitable gift."*¹⁰³

1. Lack of Statute

There is no comprehensive ordinance or statute that applies to charitable organizations in Hong Kong. Depending on the legal structure under which the charitable organization is formed, different laws apply, a fact that may be the cause of some of the difficulties in understanding the local law.¹⁰⁴

"Charity" is not a distinct legal entity, and different legal entities may qualify as charitable organizations. A charitable organization has a status granted by the IRO based on the IRO, which exempts any charitable organization from profits tax.¹⁰⁵ A charitable organization can be formed as a trust, as a society, as a statutory body established under specific ordinance, or as a company limited by shares or limited by guarantee.¹⁰⁶ As a result, the Companies Ordinance, the Societies Ordinance, or the Registered Trustees Incorporation Ordinance may apply.¹⁰⁷ The IRO also contains a provision on the dissolution of charitable organizations. This means that charitable organizations seeking tax exemption under section 88 IRO have to specify how the remaining assets of the organization should be dealt with. Additional specific requirements are

⁹⁹ Breen, Ireland Pemsel Plus, 75.

¹⁰⁰ South China Morning Post, *Spirit of Giving*.

¹⁰¹ South China Morning Post, Shirley Kwok, *Bogus Charities Duping Public*, 8 April 1995, 46.

¹⁰² *Id.*, 50.

¹⁰³ *In re Tetley* [1922 T 468]; [1923] 1 Ch 258, at 266 (CA).

¹⁰⁴ It has prompted the Ombudsman to the comment that the law is "partial and patchy, fragmented and ineffective." Office of the Ombudsman, Investigation Report, para. 6.1 c.

¹⁰⁵ Section 88 IRO, Cap 112.

¹⁰⁶ Also see Law Reform Commission of Hong Kong, Report, Charities, December 2013, 83, <http://www.hkreform.gov.hk/en/publications/rcharities.htm>. For a typology of charitable organizations in Hong Kong see Lam, Perry, The Role of the Nonprofit Sector in Hong Kong's Development, 358 [graphic with number of charities classified according to the legal form used].

¹⁰⁷ Another statute further states that unauthorized collection of donations may be punished with HKD 2,000 or 3 months imprisonment (Section 4 (17) (i) Summary Offenses Ordinance, Cap 228).

imposed by the SWD, Home Affairs Bureau, Education Bureau, and Department of Health on charitable organizations falling under their authority.¹⁰⁸

A main criticism concerns the definition of charitable organization, which follows the rule set down in *Income Tax Special Purposes Commissioners v. Pemsel*.¹⁰⁹ This decision is based on the statute of Elizabeth of 1601, entitled *An Acte to redresse of Landes Goodes and Stockes of Money hereto given to Charitable Uses*. Introduced in response to the devastation of war and the dissolution of monasteries, the act attempted to channel private help to sectors of public need.¹¹⁰ *Income Tax Special Purposes Commissioners v. Pemsel* specifies those purposes recognized as charitable.¹¹¹ The decision states that in order to be considered a charity, an organization must be established for a so-called charitable purpose such as relief of poverty, advancement of education, advancement of religion, or any other purpose beneficial to the community. The purpose must be for the public benefit.¹¹²

Since then, additional charitable purposes were recognized under the general category of other purposes that benefit the community. The Hong Kong courts, for example, have decided that “the development of culture” is covered under the charitable purpose of advancement of education.¹¹³ On the other hand, it has ruled that the encouragement of sports is not a charitable purpose.¹¹⁴ Meanwhile, the charity law in Hong Kong comprises eleven different charitable purposes,¹¹⁵ to which the reform proposes to add another three.¹¹⁶

These charitable purposes are deemed controversial because they do not reflect the values of a modern society.¹¹⁷ The definition of charity is further complicated by provisions applicable to charitable organizations scattered over the IRO (Cap. 112) and the Registered Trustees Incorporation Ordinance (Cap. 306, “TIO”). While the IRO remains silent on defining charitable purposes, the TIO includes a definition of charitable purposes that does not match the ones acknowledged by the IRD.¹¹⁸ This adds further confusion to the law. The Law Reform Commission has recommended statutory definitions of charitable purposes. However, the decision shows the challenges any reform is facing.

¹⁰⁸ Law Reform Commission of Hong Kong, Charities Sub-Committee, Consultation Paper, 103.

¹⁰⁹ [1891] A.C. 531.

¹¹⁰ O’Halloran, Wyatt, Hunter, et al., *Charity Law Reform*, 165.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ Cf. e.g. *Ng Chi-fong v. Hui Ho Pui-fun* [1987] HKLR 462.

¹¹⁴ Departmental Interpretation and Practice Notes, No. 37 (Revised) Concessionary Deductions: Section 26C: Approved Charitable Donations (Sept. 2006), at para. 9, http://www.ird.gov.hk/eng/pdf/e_dipn37.pdf.

¹¹⁵ Law Reform Commission of Hong Kong, Charities Sub-Committee, Consultation Paper, 50: Relief of poor people, Relief of victims of a particular disaster, Relief of sickness, Relief of physically and mentally disabled, Establishment or maintenance of non-profit-making schools, Provision of scholarships, Diffusion of knowledge of particular academic subjects, Establishment or maintenance of a church, establishment of religious institutions of a public character, Prevention of cruelty to animals, Protection and safeguarding of the environment or countryside.

¹¹⁶ *Id.* Moreover, it is confusing that section 2(1) TIO, Cap. 306 puts forward a different definition of the charitable purpose.

¹¹⁷ Departmental Interpretation and Practice Notes, No. 37 (Revised), Para. 9.

¹¹⁸ See section 2(1) TIO, Cap. 306.

“[A]n attempt to define charity by any of these means would be fraught with difficulty, and might put at risk the flexibility of the present law which is both its strength and its most valuable feature. In particular, consider that there would be great dangers in attempting to specify in statute those objects which are to be regarded as charitable.”¹¹⁹

2. Lack of Registration, Monitoring, and Supervision System

Charitable organizations in Hong Kong also lack any comprehensive registration, monitoring, or supervision system. The rules are piecemeal, and different authorities are in charge. The IRD keeps a public directory of approved charitable organizations on its website.¹²⁰ The Companies Registry maintains another registry, which covers all charitable organizations formed under the Company Ordinance and which includes valuable information about the organizations; however, the directory does not distinguish between for-profit companies and organizations with approved charitable missions. If a charitable organization is not listed in the directory of the IRD, citizens cannot obtain information about it. Another brief directory of charitable organizations covers trust funds for which the Home Affairs Bureau is the trustee.¹²¹ The lack of a comprehensive directory including all approved charitable organizations is a major concern because it hinders the public from ascertaining the legal status of an organization.¹²² A directory would improve the system and would address the problem of monitoring charitable activities.

Furthermore, there is a limited system of monitoring in place. When charitable organizations apply to conduct fundraising activities in public places, colloquially described as *flag days*, permission must be granted by the Social Welfare Department.¹²³ Alternatively, if funds are raised through a lottery, the charitable organization must first have been granted a license from the Commissioner for Television and Entertainment Licensing.¹²⁴ However, charitable organizations can escape this control if they do not undertake fundraising in public (flag days) and do not engage in activities with an element of chance (lotteries). Fundraising activities are monitored by the government only if they require authorization by the SWD or the Television and Entertainment Licensing Authority.¹²⁵ When it does occur, the monitoring is confined to the funds raised through the specific fundraising activity in the application.¹²⁶

In addition to the lack of a proper registration system and the lack of a monitoring system, different government authorities are involved in the administration of charitable organizations. This is another barrier for the adequate registration and monitoring of charitable organizations.

¹¹⁹ UK Home Office, *Charities: A Framework for the Future* (1989) Cm 694 White Paper, at para. 2.11.

¹²⁰ http://www.ird.gov.hk/eng/tax/ach_index.htm. The list of approved charitable organizations runs over 939 pages. See http://www.ird.gov.hk/eng/pdf/e_s88list_emb.pdf.

¹²¹ http://www.hab.gov.hk/en/policy_responsibilities/District_Community_and_Public_Relations/trustfnd.htm.

¹²² Law Reform Commission of Hong Kong, *Charities Sub-Committee, Consultation Paper*, 91.

¹²³ See section 4(17)(i) of the Summary Offences Ordinance, Cap. 228.

¹²⁴ Gambling Ordinance, Cap. 148.

¹²⁵ Office of the Ombudsman, *Investigation Report*, 5.5.

¹²⁶ *Id.*, 5.6.

3. No Disclosure Requirements

Charitable organizations face essentially no disclosure requirements. No statutory provisions oblige charitable organizations to submit annual reports or financial overviews to a supervision body.¹²⁷ The IRD may occasionally review an organization's charitable status by examining financial statements, annual reports, and accounts, but this is not mandatory.¹²⁸ A charitable organization formed as a company must submit audited accounts to the IRD every four years, but charitable organizations formed as trusts or societies are required to present only self-certified accounts. Charitable organizations formed under the Companies Ordinance must file their reports with the Companies Registry annually,¹²⁹ but this only covers basic information such as address, board of directors, and any outstanding mortgages. Unincorporated organizations are under no such duty at all.

By contrast, a charitable organization established as statutory body may be subject to stringent control.¹³⁰ The Tung Wah Ordinance and the Po Leung Kok Ordinance oblige their boards to keep proper records of all transactions of the organization. The books have to be open for inspection by any director and by any person appointed by the Chief Executive Officer of Hong Kong. They also have to be audited by a certified public accountant.

E. The Reform

These criticisms are addressed by the Law Reform Commission in its eighteen recommendations. The core of the reform is to strengthen public trust in the charitable sector, for which recommendations on better governance and accountability standards were put forward. The recommendations range from voluntary codes of conducts to mandatory statutory provisions, and they concern both private and public law rules. The reform attempts to strengthen transparency not only by increasing disclosure standards but also by clarifying the law to make it more accessible to the public in general. Enforcement measures are also proposed, which reflects the understanding that strengthening transparency standards must go in tandem with enforcement rules. The high number of responses received during the consultation process proves that the reform is a topic of public concern and not confined to the political arena.

“Some in our community expect Government to monitor each and every fundraising-activity to prevent malpractices: this is not realistic. Another body of community opinion suggests total non-intervention by Government: donors pick the beneficiaries of their choice and rely on the reputation of the charities concerned. This involves a risk of unscrupulous or fraudulent fund-raisers passing off as established and responsible charities.”¹³¹

1. Eighteen Recommendations

The first two recommendations concern the definitions of charity and charitable purpose. The commission suggested introducing a clear statutory definition of what constitutes a

¹²⁷ Section 51 (1), Cap. 112.

¹²⁸ Inland Revenue Department information pamphlet, *A Tax Guide for Charitable Institutions and Trusts of a Public Character* (revised ed. Sept. 2010), at para. 17, http://www.ird.gov.hk/eng/tax/ach_tgc.htm.

¹²⁹ Section 107 Cap. 32.

¹³⁰ See e.g. Tung Wah Group of Hospitals Ordinance, Cap. 1051; Po Leung Kuk, Cap. 1040.

¹³¹ Office of the Ombudsman, *Investigation Report*, 12.

charitable purpose.¹³² This comes together with a change in understanding of charity, which nowadays covers general philanthropic undertakings and not only aid to the poor.

“While the essential characteristics of charitable purposes do not change, what will satisfy those purposes changes with society.... What is charitable is to be determined in accordance with contemporary community values. A contemporary activity may be charitable now, though it would not have been charitable a century ago, or less.... Rules established a century ago relating to what is charitable need to be revisited in this light.”¹³³

However, defining specified charitable purposes only makes practical sense when a regulator has powers to condemn acts of organizations that go beyond their permitted scope. The commission recommends that the IRD should undertake frequent reviews of the accounts of charitable organizations to ensure that the money is spent in compliance with their charitable objects.¹³⁴ The IRD is indeed the proper body to make such inquiries, but any further responsibility is practical only if it is accompanied by additional manpower. Further, this rule would make practical sense only if the IRD had authority to enforce actions upon non-compliance. These aspects would need to be considered by the Law Commission.

As to the legal forms available for charitable organizations, the commission found the current situation to be satisfactory and did not recommend any changes.¹³⁵ This conclusion is to be welcomed, because a specific legal entity for charitable organizations would have only further complicated the law. However, given the fragmentation of legal rules among several statutes, it would be helpful if clear information on the regulatory system was provided.

The commission made fundamental recommendations to improve the governance and accountability of charitable organizations. All charitable organizations which publicly solicit for donations and which seek tax exemption should be subject to the requirement of registration, and their list should be publicly available.¹³⁶ The commission preferred this approach rather than establishing a centralized charity body.¹³⁷ Furthermore, a specific financial reporting standard should be adopted,¹³⁸ and charitable organizations exceeding a certain annual income should be under a duty to file audited financial statements.¹³⁹ All other charitable organizations should make information such as financial statements and activities reports available on their websites.¹⁴⁰ If the organizations do not comply with these requirements, the government should be responsible for enforcement actions.¹⁴¹

¹³² Law Reform Commission of Hong Kong, Report, Recommendation 1 and 2, 23, 81.

¹³³ *Aid/Watch Incorporated v Commissioner of Taxes* [2008] AATA 652, pars. 16-17 (Justice Downes).

¹³⁴ Law Reform Commission of Hong Kong, Report, Recommendation 16, 189.

¹³⁵ *Id.*, Recommendation 3, 91.

¹³⁶ *Id.*, Recommendation 4, 107.

¹³⁷ *Id.*, Recommendation 18, 226. Similarly to a centralized charity commission, Edith Terry suggested a Hong Kong center for philanthropy, which would function like “a clearing house for information and best practices.” <http://www.scmp.com/node/530396>.

¹³⁸ Law Reform Commission of Hong Kong, Report, Recommendation 5, 129.

¹³⁹ *Id.*, Recommendation 6, 130.

¹⁴⁰ *Id.*, Recommendation 7, 131.

¹⁴¹ *Id.*, Recommendation 8, 140.

Such a registration requirement covering all tax-exempt charitable organizations would help people know which organizations qualify. The transparency rules are imperative. In essence, additional bureaucracy does not provide for a better framework for regulation, and the proposed requirements of registration coupled with increased disclosure duties would be the right move forward.

“We consider a responsible charity to have a duty to be open, transparent and publicly accountable, even where they are not legally required to do so. They should maintain a high standard of integrity.”¹⁴²

The commission also made recommendations as to the regulation of fundraising activities. It recommended adoption of a standardized application form for certain fundraising activities.¹⁴³ It also recommended the establishment of a centralized hotline for complaints.¹⁴⁴ When raising funds, a charitable organization must clearly identify itself by displaying the registration number¹⁴⁵ and thereby follow codes of good practices.¹⁴⁶ The public should also be educated on the fundraising activities to raise awareness of charitable organizations and their operations.¹⁴⁷ In addition, more resources should be allocated for government departments to intensify supervision,¹⁴⁸ and a platform should be set up between the independent departments so they can deal more efficiently with inquiries and applications.¹⁴⁹

Furthermore, the commission suggested broadening the *cy-près* doctrine to ensure that property can be distributed not only where a charitable organization is being dissolved but also where property given for a specific charitable purpose cannot be returned to the donor and attainment of the purpose have failed.¹⁵⁰ This recommendation is overdue. By adopting such a broader doctrine Hong Kong would align its rules to other common law jurisdictions.

2. Aspects Left Out of the Reform

Although the report by the Law Reform Commission is comprehensive, a number of considerations have unfortunately been left out.

To begin with, it is regrettable that the charity reform ignored the important topic of so-called social ventures, which try to do good while also making money.¹⁵¹ Although social

¹⁴² Office of the Ombudsman, Investigation Report, 5.11.

¹⁴³ Law Reform Commission of Hong Kong, Report, Recommendation 9, 161.

¹⁴⁴ *Id.*, Recommendation 10, 164.

¹⁴⁵ *Id.*, Recommendation 11, 168.

¹⁴⁶ *Id.*, Recommendation 12, 173.

¹⁴⁷ *Id.*, Recommendation 13, 175.

¹⁴⁸ *Id.*, Recommendation 15, 178.

¹⁴⁹ *Id.*, Recommendation 14, 178.

¹⁵⁰ *Id.*, Recommendation 17, 204.

¹⁵¹ Despite their significant importance, the government has largely ignored the legal perspective of social ventures and excluded them from the charity reform. The problem is that social ventures are caught in the trap of the bipolarity of the Hong Kong company law, which either allows a company to be for-profit or not-for-profit but nothing in between. If this problem was addressed, clear distinctions could be drawn between organizations which entirely rely on donations and such which make money while they also do good. But given the clear emphasis on social entrepreneurship in Hong Kong, the traditional law of charitable organizations at least seems outdated.

ventures have evolved into a fundamental and integral part of the business landscape, they continue to live a precarious existence in Hong Kong.¹⁵²

Methodological justification is another omission. Besides the law of Hong Kong, the reform commission studied the law of other Ireland, England and Wales, Scotland, Singapore, Australia, Canada, and New Zealand. This comparative examination, however, does not consider those features of the Hong Kong charitable sector that are based on the culture and traditions of the Hong Kong people.¹⁵³ Other than Singapore, only Western jurisdictions with a distinctively different charitable sector were examined. What may be needed is a regulatory concept of charity based not on a Western understanding of charity but on a specifically Asian understanding, one that takes the peculiarities of Chinese traditions into consideration. Inadequate regulation could turn into overregulation, which might deter citizens from making donations. The reform must not merely incorporate other countries' regulatory parameters; instead, it ought to identify and develop an appropriate regulatory system for Hong Kong.

"Asia is fundamentally different.... The theories regarding philanthropy have all emerged from the west. While they have their good aspects, I believe that Asia will develop its own unique brand of philanthropy."¹⁵⁴

Furthermore, the new regulatory system must fit the macroeconomic structures of Hong Kong. Hong Kong's economy has peculiar characteristics. Some have described Hong Kong as the freest economy in the world.¹⁵⁵ Others, however, have stressed that the economy is dominated and steered by a handful of local tycoons.¹⁵⁶ This picture is mirrored in the charitable sector, which is largely dominated by the few charitable organizations of Hong Kong tycoons. "Dominated" means that many of the small charitable organizations depend on the large charities, which act as financiers to smaller projects. These large charities introduce a kind of regulation in the market, because they use their liquidity to implement projects according to their own choice and standards and thereby operate as regulators over smaller charitable organizations. But the major charitable enterprises themselves act outside the realm of regulation. This essential aspect ought to be considered in the reform. Regrettably, it has been ignored. Before the reform moves on, the implications of this macroeconomic situation must be taken into account in order to design the appropriate regulatory model.

Another important aspect left out of the reform is the tax system. Charity law is closely intertwined with aspects of taxation because charitable organizations are commonly tax-exempt, and donations to such organizations are usually tax-deductible. Deductions for donations to approved charitable organizations can be made up to 35 percent of the total chargeable salaries or profits tax but must in any case not be lower than HK\$100 one-off.¹⁵⁷ Tax planning is an essential issue for wealthy people, who usually prefer to give to organizations of their own

¹⁵² Id.

¹⁵³ Cf. *supra* chap II.

¹⁵⁴ South China Morning Post, *Spirit of Giving*.

¹⁵⁵ Cf. e.g. Heritage Foundation, Index of Economic Freedom 2015, <http://www.heritage.org/index/country/hongkong>.

¹⁵⁶ CNN, Sophia Yan, *Hong Kong has a tycoon problem*, <http://money.cnn.com/2014/11/02/news/economy/hong-kong-tycoons>.

¹⁵⁷ Sections 16D and 26C IRO, Cap. 112.

choice rather than to the government. Nonetheless, the situation is more intractable in Hong Kong because tax considerations only play a limited role when donors decide to make a donation. In Hong Kong, the standard rate for personal income is 15 percent and for corporations 16.5 percent, while there is no capital gains tax or investment income tax. This leaves more disposable income to the people while creating only small tax incentives for donations. Although such considerations may be decisive for some people, they are largely irrelevant for others. Super-donations play by different rules. They are not motivated by tax considerations, because the money is usually derived from investment gains or stock dividends; if not, any such donation would most certainly be well beyond the cap of 35 percent. This reinforces the conclusion that the charitable behavior of the Hong Kong people is engraved in culture and traditions.¹⁵⁸ Monetary considerations such as tax incentives are of minor importance.

Hong Kong is also aware that charitable organizations may be misused for terrorist financing, but it regards the risk as low. The topic is ignored in the report.¹⁵⁹ As a member of the Financial Action Task Force (FATF), Hong Kong is bound by the Special Recommendation VIII, which obliges member states to prevent charitable organizations from financing terrorism. Based on this international code of best practice, Hong Kong has compiled guidelines for charitable organizations.¹⁶⁰ These guidelines suggest that strong corporate governance, responsible service management, financial transparency, and accountability are required for an anti-terrorist financing framework to be effective.¹⁶¹ They also suggest a *Know Your Donor* principle and introduce a suspicious transaction system.¹⁶² In addition, the guidelines set forth recommendations for supervising and monitoring charitable organizations.¹⁶³ Furthermore, Hong Kong has adopted the Organized and Serious Crimes Ordinance, which aligns the local legislation to the Forty Recommendations and Nine Special Recommendations of the FATF relevant in context of money laundering.¹⁶⁴ These rules create liability for anyone involved in money laundering who fails to report knowledge or suspicion to authorities. The institute of chartered secretaries has also published guidelines against money laundering and terrorist financing, and it encourages its secretaries to track each organization's charitable purpose, its sources of income and donations, and the people behind it.¹⁶⁵ Given these international commitments, it is surprising that the topic was not mentioned in the report.

¹⁵⁸ Cf. supra chapter 0

¹⁵⁹ Narcotics Division Security Bureau' An Advisory Guideline on Preventing the Misuse of Charities for Terrorist Financing' July 2007, para. 1.2, <http://www.nd.gov.hk/pdf/guideline-e.pdf>.

¹⁶⁰ Id.

¹⁶¹ Id., chapter 3.

¹⁶² Id., chapter 4.

¹⁶³ FATF, Interpretative Note to Special Recommendation VIII: Non-profit Organizations, 6 b, <http://www.un.org/en/sc/ctc/docs/bestpractices/fatf/9specialrec/9special-rec8.pdf>.

¹⁶⁴ Cf. Organized and Serious Crimes Ordinance, Cap 455. One should also mention the United Nations (Anti-Terrorism Measures) Ordinance, Cap. 575 (UNATMO).

¹⁶⁵ Hong Kong Institute of Chartered Secretaries, Anti-Money Laundering and Counter-Terrorist Financing – Guidelines, para. 5.5, 19, http://www.hkics.org.hk/media/publication/attachment/2141_AML%20Guidelines.pdf.

F. Charity Watchdogs – An Alternative Form of Regulation

The charitable sector obviously needs some kind of regulation to provide transparency and ensure adherence to generally applicable established rules and principles. But is the proposed regulatory framework a constructive way forward? Although current law is inadequate, an ineffective regulatory system will not be an improvement. Regulatory reform should never be an end in itself; there ought to be an overarching justification for any legislative intervention. In the absence of such a justification, alternative models must be considered.

A possible solution to increase transparency and enhance trust in the charitable sector in Hong Kong would be the establishment of an independent charity evaluator. Such a charity evaluator or watchdog is a sensible form of regulation that would resolve some of the inadequacies of the current system. After examining accountability and transparency standards, corporate governance rules, and financial statements, the watchdog would grant a charity a seal of quality that informs the public. Charity evaluators bridge the gap between charitable organizations and donors by interpreting information on the charitable organization and making it accessible to the donors and the public.¹⁶⁶ By doing this, they promote transparency, improve accountability, strengthen governance of such organizations, and enhance efficiency of their work.¹⁶⁷

*“Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”*¹⁶⁸

However, charity watchdogs are not without critics.¹⁶⁹ Charity ratings have significant effects on the behavior of donors, which may suggest that donors sometimes put excessive reliance on ratings.¹⁷⁰ Thus, a rating score may also be regarded as a form of coercion, pressuring charitable organizations to comply with requirements for a favorable rating out of fear of losing out to other organizations.¹⁷¹ One may also be concerned that powerful rating agencies could be in the position to steer and manipulate donors. An example of such concern is a lawsuit between the American Institute of Philanthropy (AIP) and a charitable organization (Father Flanagan’s Boys Home). The AIP graded that charity as one of the “least needy charities” because of its large accumulated assets. The dispute triggered the director of the charity to say that “the

¹⁶⁶ Cf. Teresa P. Gordon, Cathryn L. Knock, Daniel G. Neely, *The Role of rating agencies in the market for charitable contributions: An empirical test*, Journal of Accounting and Public Policy, 28 (2009), 469.

¹⁶⁷ Margaret F. Sloan, *The Effects of Nonprofit Accountability Ratings on Donor Behavior*, Nonprofit and Voluntary Sector Quarterly, 38 (2009), 220; but critically, Jennifer A. Lammers, *Know Your Ratios? Everyone Else Does*, The Nonprofit Quarterly, 10 (2003), 1; Tobin Aldrich, *Benchmarking the fundraising performance of UK charities*, International Journal of Nonprofit and Voluntary Sector Marketing, 14 (2009), 353.

¹⁶⁸ Justice Louis D. Brandeis.

¹⁶⁹ Cf. e.g. Prives D, *Charity Standards Proposed by Watchdog Group Are Deeply Flawed*, <https://philanthropy.com/article/Charity-Standards-Proposed-by/51592>; also see Bruce R. Hopkins, *The Law of Fundraising*, 3rd ed., John Wiley & Sons, 2002, chapter 8. But positively, Aldrich, *Benchmarking the fundraising performance of UK charities*.

¹⁷⁰ Vidhi Chhaochharia and Suman Ghosh, *Do Charity Ratings Matter?*, <http://home.fau.edu/sghosh/web/images/CharityFeb19.pdf>; but critically Jordan E Silvergleid, *Effects of watchdog organizations on the social capital market*, Philanthropic Fundraising, 2003, 7.

¹⁷¹ Cf. Hopkins, *The Law of Fundraising*, 447.

watchdog has become an attack dog. Somebody has to muzzle it. It is causing great harm to worthy charities.”¹⁷²

These concerns are, however, unjustified in Hong Kong. People in Hong Kong show a different donor-behavior. As noted earlier, tax incentives play little role. Donors give because they like to give.¹⁷³ Accordingly, donors want to ensure that an organization complies with the standards set upon them. In other words, it is necessary for donors that they can identify themselves with the recipient of their donations.

Moreover, the charitable organizations of the Hong Kong tycoons would remain unaffected by these ratings, because they do not rely on donations from the public; instead, they are funded by the super-donations of the tycoons themselves. Although a bad rating might impair their reputations, there would be no financial consequences. Small charitable organizations, by contrast, would be motivated to earn ratings that would allow them to present themselves in a positive light to the public. In their case, such an excess of watchdog-power could occur, but given the various types of donors involved (government, private donors, and the trusts of the tycoons), an over-reliance is unlikely. Also, the media can monitor the power of watchdogs—as it has done in Hong Kong.¹⁷⁴ However, in order to forestall suspicion, it would be helpful if watchdogs were required to publish annual reports about their work and a rating guide clearly setting out their parameters and ratings. Such a requirement would enable watchdogs to make the charitable sector more professional and to improve accountability, transparency, and governance of charitable organizations.

Despite the strong charitable sector in Hong Kong, the idea of a charity evaluator is rather new. A single charity evaluator has emerged in Hong Kong, called iDonate. Another initiative, WiseGiving, does not qualify as a watchdog; instead it is a mere intermediary that makes information accessible to the public.

1. iDonate

The charity watchdog iDonate awards each organization a rating score based on the information disclosed.¹⁷⁵ It covers around 2,000 charitable organizations, of which the majority are organizations incorporated under the Companies Ordinance and are tax-exempt under section 88 of the IR. iDonate thereby relies on annual reports downloaded from the websites of charitable organizations and audited financial reports purchased from the Integrated Companies Registry Information System.¹⁷⁶ In the first part of the analysis, iDonate uses this information to calculate the operational efficiency of each charitable organization based on factors such as fundraising efficiency, fundraising expense, project expense, salaries, and administrative expense. The rating scores are based on parameters, each of which uses a ten-point scoring system. The higher the score, the better the operational efficiency of the organization (as defined by iDonate). In the second part of the analysis, iDonate uses the working capital ratio and the

¹⁷² The dispute was settled in court. For more see Hopkins, *The Law of Fundraising*, 442.

¹⁷³ *Id.*

¹⁷⁴ Cf. <http://www.theidonate.com/en/media>.

¹⁷⁵ iDonate is similar to the charity watchdogs known from the US such as Charity Navigator or BBB Wise Giving Alliance.

¹⁷⁶ Cf. <http://www.theidonate.com/en/methodology>.

surplus-to-donation ratio to estimate the charitable organization's effective need for funds. This parameter is helpful for donors who wish to fund an organization that will invest the donations immediately. iDonate also comments on the transparency of a charitable organization, which indicates the credibility of the rating. These parameters allow the public to get a clearer understanding of the organization.

The iDonate approach to fundraising efficiency is straightforward. An organization that spends HK\$50 to raise HK\$100 is highly inefficient and receives a lower score than an organization that spends HK\$50 to raise HK\$500.

The assessment of fundraising expenses indicates how much the organization spends on its charitable purpose. However, fundraising activities may also serve another interest, by helping spread the mission of a charitable organization. Treating these efforts solely as fundraising expenses is hard to justify. This criticism could perhaps be addressed with proper accounting tools, which is indeed one of the recommendations of the Law Reform Commission. But the recommendation would need to differentiate between fundraising costs which merely seek to raise funds and those that also promote the charitable mission.

iDonate also puts project expense in relation to total expenses. Again, the higher the ratio, the greater the organization's efficiency. The problem here is another accounting issue: specifically, what can be regarded as project expense? If a charity spends money on an awareness campaign that also calls for donation, does it count as project expense or fundraising expense?

Similar issues can arise concerning iDonate's measure of staff salaries in relation to the total expenditures of the organization. An isolated look at this number can be misleading, because highly effective charitable organizations need to pay competitive salaries to attract the most talented staff. A particular salary may be assigned to project costs if the employee works exclusively on a project, but not if his or her work concerns strategic or general operational decisions. It is in any case wrong to expect people in the NGO sector to work for free.¹⁷⁷ "Such an attitude implies that community work is unworthy of full payment when compared with the commercial sector because the Third Sector is seen essentially as the charity sector where people should work with at least some volunteering spirit. This assumption may misconceive the role of the Third Sector in a modern society, and lead to continuing under-valuation of the sector's importance and runs counter to the need to attract good people to work full-time in the Third Sector."¹⁷⁸ These aspects would need to be addressed by the Law Commission through carefully developed accounting standards.

Unfortunately, iDonate does not rank the governance of charitable organizations. Doing so using the neutral calculus of numbers would be no more difficult than developing financial standards. For example, the numerical rating might depend on whether the organization follows any governance standards, whether the board discloses conflicts of interests, whether the board convenes on a regular basis, and so forth.

If a charitable organization receives a low score, iDonate may make suggestions on how the rating could be improved. It may, for example, suggest that the organization needs

¹⁷⁷ Education and Research, Study on the Third Sector Landscape in Hong Kong, 26.

¹⁷⁸ Id.

managerial support and that it should attempt to improve the ratio of expenses and donations by increasing its income. This methodology confronts the charitable organization with its low rating and gives it a chance to improve its score. It thereby serves an educational function that is essential for the accountability of the sector. However, so-called winner rankings, such as lists of the charities with the greatest administrative expenses, improperly isolate certain facts.¹⁷⁹ Such rankings may be good for publicity, but they do not adequately inform donors.

2. WiseGiving

Whereas iDonate analyzes information on charities, WiseGiving merely makes the raw data available on its website, www.wisegiving.org.hk.¹⁸⁰ The service is free of charge, and charitable organizations may join the platform by submitting a set of documents that WiseGiving then will verify.¹⁸¹ WiseGiving publishes basic information about each organization, including financial statements, governance, mission, and charitable services. The financials are broken down in a simple and comprehensive way that allows the public to understand details of income and expenditures. The website also lists the current board of trustees by name and notes their compensation, if any. To remain on the website, an organization must submit updated documents each year. WiseGiving does not interpret the information or rate the organizations. It simply facilitates access to the information.

WiseGiving monitors about 247¹⁸² local charitable organizations. Unlike the private organization iDonate, WiseGiving is a governmental initiative, founded by the Hong Kong Council of Social Service (HKCSS).

3. Analysis

It is important to distinguish between WiseGiving and iDonate. Both aim at improving transparency, accountability, and governance, but their means differ. WiseGiving does not interpret the information provided by charitable organizations. It functions as a mere intermediary between the charitable organizations and the public. By contrast, iDonate is a rating agency.

But regardless of their different approaches, both WiseGiving and iDonate enhance accountability and transparency of charitable organizations. They disclose charitable organizations' flaws to the public. Facing the potential consequences of their wrongful (and sometimes maybe criminal) conduct,¹⁸³ charitable organizations will do more to avoid mistakes.¹⁸⁴ With its ratings, iDonate is the more effective of the two. The raw data that WiseGiving provides require donors to perform their own thorough analysis.

¹⁷⁹ Cf. <http://www.theidonate.com/en/aboutus>.

¹⁸⁰ South China Morning Post, Nora Tang, *Watchdog Steps Up Pressure on Non-Transparent Hong Kong Charities*, 21, May 2013, <http://www.scmp.com/lifestyle/family-education/article/1242049/watchdog-steps-pressure-non-transparent-hong-kong>.

¹⁸¹ Cf. <http://www.wisegiving.org.hk/en/wisegivinglogo.aspx>.

¹⁸² According to the results that appeared in their search engine.

¹⁸³ Dana Brakman Reiser, *There Ought to Be a Law. The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, Chicago-Kent Law Review, 80 (2005), 580.

¹⁸⁴ *Id.*

WiseGiving and iDonate both improve transparency of charitable organizations. iDonate also reveals whether an organization voluntarily publishes annual reports and financial statements. They base their assessment on information provided by the organization itself or otherwise freely accessible. Left to their own devices, charitable organizations might withhold negative information from the public. WiseGiving and iDonate operate as direct incentives to make relevant information accessible to the public, so that all organizations can be evaluated on the same set of information. As a further consequence of higher accountability standards and improved transparency, WiseGiving and iDonate facilitate the punishment of misbehavior by governmental authorities.¹⁸⁵

WiseGiving may also strengthen governance of charitable organizations, by providing information on members of the board of an organization, their general profile, their compensation, their duties, and the number of meetings they have held in the past financial year. This information allows the public to get a better understanding of the organization. Governance standards are unfortunately not considered by iDonate.

While iDonate is an important effort to increase transparency, accountability, and governance of charitable organizations in Hong Kong, one must not take its ratings as absolute and final truth.¹⁸⁶ Ratings are only one part of the picture. Other “soft” factors must be considered too. A donor may make decisions based on a relationship of trust nurtured by personal contact with the organization, for example, rather than based on the relation between spending and administrative and project costs. Similarly, some donors may value the ability to give a project a personal touch by being part of the planning and implementation more highly than neutral ratings.

The good done by a charity cannot be measured precisely. Parameters provide at most an approximation. If we focus predominantly on overhead, we can create what the Stanford Social Innovation Review has coined “The Nonprofit Starvation Cycle.”¹⁸⁷ We starve charities of the freedom they need to best serve the people they are trying to serve. A high efficiency ratio does not guarantee that the project is well and wisely managed.

By enhancing transparency and accountability and by educating the public, such organizations as iDonate and WiseGiving serve as an alternative or at least a supplement to legal rules. The Law Reform Commission must acknowledge their important role. In order to facilitate their work, the government must adopt a publicly accessible system in which all tax-exempt organizations are registered. Such a central registration system does not require new laws. It would enhance the quality of the charitable sector and provide the market with the tools to regulate itself.

IV. Summary

Charitable organizations in Hong Kong have developed under a very loose regulatory regime. The Law Reform Commission has recently put forward a report with 18 recommendations for improving charity law. While the Law Reform Commission undertook a

¹⁸⁵ Id., 597.

¹⁸⁶ iDonate refers to this aspect on its website and encourages donors to do more specific due diligence before making a donation: see <http://www.theidonate.com/en/methodology>.

¹⁸⁷ Ann Goggins Gregory and Don Howard, *The Nonprofit Starvation Cycle*, Stanford Social Innovation Review, Fall 2009, 49.

comprehensive comparative review, it failed to consider essential aspects specific to Hong Kong: the people's unique understanding of charitable giving, based on Chinese tradition and customs; the minor importance of monetary incentives such as tax deductions, compared to people's sense of obligation towards their communities; and the dominant influence of the tycoons, who impose their own rules on the sector.

In place of the Law Reform Commission's recommendations, a preferable system would rely on self-regulation informed by charity watchdogs. In order for this system to be effective, the Law Reform Commission must only introduce a publicly accessible registration system for all charitable organizations in Hong Kong. The suggested model would require minimal alteration of the law.

Article

FREEDOMS OF ASSOCIATION AND ASSEMBLY AND NGO REGULATION IN GREECE AND ENGLAND

KONSTANTINOS D. MAGLIVERAS¹

I. Introduction

As in other European countries, thousands of nongovernmental organizations (NGOs) have been established and are currently in operation in Greece. Their precise number is not known, not least because Greece, unlike jurisdictions such as England, has no central registry for NGOs and no other public country-wide method to record their creation and dissolution.

There is also no generally acceptable definition of “NGO”. For the purposes of this article, NGO is defined as an association of individuals, who have freely agreed to pursue specific purposes and goals (other than creating syndicates, collective bargaining bodies, trade unions, or political parties) and who carry out the mandate without aiming for direct profit or gains, monetary or otherwise—provided, first, that activities benefit the general public; second, that the organization has been established and is regulated by a constitutive instrument; and third, that it has received some form of official recognition by a competent public authority and is subject to State supervision.

This article compares the NGO regulatory regimes of Greece and England. It concludes by recommending that Greece add the legal entity “nongovernmental organization” to its Civil Code and regulate it according to the role it plays in societal affairs, similar to the special treatment of organizations designated “charities” in English law.

Both Greece and England accept and uphold international and regional human rights law. Both also recognize the competence of multilateral judicial and quasi-judicial organs, including the European Court of Human Rights. Even so, the two countries differ in four pertinent respects. First is the type of legal system. Greece is a civil law or Continental law country, whereas England is a common law country. Second is the duration of a pertinent legal tradition. Charitable institutions are much more firmly embedded in the Anglo-Saxon world than in Continental Europe. Accordingly, when NGOs first appeared there, England already had a long and distinguished tradition of private legal entities known as charities, with a charitable or philanthropic remit to promote the common good. As a considerably more recent State, by contrast, Greece did not have such a tradition, and the founders of NGOs had and continue to have to borrow other types of legal vehicles from the Greek Civil Code in order to establish their organizations. A third difference is in the two countries’ constitutions. Greece has a written

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constitution; England does not. Finally, the two countries differ on the impacts of global and regional treaties. In the Greek legal order, treaties ratified by the Parliament take precedence over domestic law and form part of the domestic legal order without further enactments. In the United Kingdom, by contrast, treaties must be incorporated in a specific legislative instrument before they are deemed domestic law.²

II. NGOs in the Greek Legal Order

A. The Constitution of Greece

According to Article 11 of the Constitution of Greece, “Greek citizens have the right to assemble peacefully and without carrying weapons.”³ The Police are entitled to be present only during public gatherings held outdoors. Such gatherings may be prohibited on the basis of a reasoned decision by the Police if they may cause a serious risk for public safety or if the socioeconomic life in a specific area will be adversely affected. Detailed provisions on when and how public gatherings may be prohibited are to be found in a number of legislative instruments. Despite the fact that the Greek Constitution was promulgated in 1975, some of these instruments, which are still in force, were adopted when the country was under a military dictatorship (April 1967 - July 1974).

As regards the right to association, Article 12 of the Constitution provides that:

Greek citizens have the right to establish associations and not-for-profit organizations by observing the legislation, which, however, may not subject the exercise of this right to a [prior] permit [issued by a public authority].

Such organizations may not be dissolved, save when the legislation has been violated or when crucial provisions of the organizations’ charters or statutes have been breached. Even in these cases, dissolution is not automatic. It requires the prior issuance of a court judgment, which not only must record the infraction but must also conclude convincingly that the infraction is of such importance that it justifies the termination of the activities. In these instances, the dissolution can be understood as the penalty that the NGO must pay because it has breached the legislation or because its members have breached its constitutive instrument. The latter instance might be regarded as an anomaly: why should the NGO be punished and disbanded when it was the members who violated the terms of its charter? The simple answer is that the NGO is so closely knitted with its members that they are almost inseparable and the actions (or omissions) of the latter cannot but have serious and direct consequences on the former. Article 12 further stipulates that the dissolution provisions will be applied by analogy to associations of natural persons not incorporated as organizations. It is of some interest to observe that, while Article 11(2) expressly allows the legislature to lay down rules determining when public gatherings can be curtailed or even prohibited, no such stipulation is to be found as regards the exercise of the right to set up associations and not-for-profit organizations.

² Thus, while the European Human Rights Convention was ratified by the UK in March 1951, it only became part of British law through the promulgation of the Human Rights Act 1998, which came into force in October 2000.

³ All translations in the present article are the author’s.

The Constitution limits the application of the rights and freedoms laid down in Articles 11 and 12 to “Greek citizens,” seemingly excluding all aliens who live lawfully in Greece.⁴ While this restriction could have been upheld when the Constitution was first promulgated in 1975, it is now rather obsolete, at least as it applies to a specific group of aliens: the nationals of the other Member States of the European Union who have exercised the rights and freedoms conferred on them by EU law⁵ and reside in the Greek territory. Thus it can be argued that Articles 11 and 12 of the Constitution have been *de facto* amended, and the rights and freedoms enshrined therein apply by analogy to those EU nationals (i.e., the citizens of another Member State) living in Greece pursuant to the applicable rules of the European Union.

Given that the Constitution has been revised repeatedly since Greece acceded to the (then) European Economic Community in January 1981, there have been ample opportunities to harmonize its text with the compulsory rules of EU law. However, this has not happened, while there exist EU Member States which have introduced a more favorable regime for EU citizens, compared to other aliens. For example, Article 146 of the Constitution of Croatia, which was promulgated in 1990 and last amended in 2013, provides: “In the Republic of Croatia, all rights guaranteed by the European Union *acquis communautaire* shall be enjoyed by all citizens of the European Union.”⁶

The need to harmonize the text of the Greek Constitution with EU law is further supported if one were to invoke the Charter of Fundamental Rights of the European Union, which entered into force on December 1, 2009.⁷ The Charter, which was initially proclaimed as a political declaration by European leaders at the Nice European Council on December 7, 2000, became legally binding on EU institutions as well as on national governments with the coming into force of the Treaty of Lisbon (also known as “the Reform Treaty”) in December 2009. The Charter has the same legal validity as the EU’s constitutive instruments—namely, the Treaty on European Union and the Treaty on the Functioning of the European Union. The provisions of the Charter are addressed to the national authorities of Member States and are binding upon them when implementing EU law in the domestic legal order. The freedoms of assembly and association are expressly protected by Article 12(1) of the Charter, which reads:

Everyone has the right to freedom of peaceful assembly and to freedom of association at all levels, in particular in political, trade union and civic matters, which implies the right of everyone to form and to join trade unions for the protection of his or her interests.

By using the word “everyone,” Article 12(1) arguably covers the following three categories of individuals: (a) the citizens of a Member State residing in the State of nationality (e.g., a Greek citizen living in Greece); (b) the citizens of a Member State residing in a Member State other

⁴ The Greek Constitution is not the only one in Europe that limits these rights solely to its own citizens. Cf. Articles 8(1) and 9(1) of the German Constitution: “All Germans shall have the right to assemble peacefully ...” and “All Germans shall have the right to form corporations and other associations.” www.btg-bestellservice.de/pdf/80201000.pdf

⁵ Principally, the free movement of persons, including the right of establishment. See Article 3(2) of the Treaty on European Union; and Articles 26(2), 45 et seq., and 49 et seq. of the Treaty on the Functioning of the European Union, *Official Journal of the European Union*, C 83, March 30, 2010.

⁶ The text of the Constitution is available at <http://www.sabor.hr>. The term “*acquis communautaire*” denotes the totality of primary and secondary EU law, including the constitutive instruments of the European Union.

⁷ *Official Journal of the European Union*, C 83, 30.3.2010, p. 389.

than that of their nationality (e.g., a Greek citizen living in Croatia); and (c) the citizens of all non-Member States residing in any Member State (e.g., a citizen of South Sudan living in Croatia).

There are no known cases where the Greek State has deliberately violated the right to assemble and the freedom of association enjoyed by citizens of other Member States, as guaranteed by the rules of EU law, including the Charter of Fundamental Rights. For purposes of legal clarity the Constitution ought to be revised in order to state that these rights extend to all EU nationals⁸ and, in keeping with the aforementioned interpretation of the Charter, to all aliens residing lawfully in Greece as well. However, because the Greek Constitution subscribes to the principle of reciprocity in its relations with other States, it could be argued that the express enjoyment of these rights and freedoms by third-country nationals could require that the same rights are enjoyed by Greek nationals within their jurisdictions, a fact that is extremely difficult to ascertain.

B. Multilateral Human Rights Treaties Binding Greece⁹

As regards the global and regional treaties for the protection and promotion of human rights which have been ratified by Greece, reference will be made to the International Covenant on Civil and Political Rights (ICCPR), adopted under the auspices of the General Assembly of the United Nations in 1966,¹⁰ and to the aforementioned European Human Rights Convention (ECHR), adopted by the Council of Europe in 1950.¹¹

1. Treaty Enforcement

As noted above, international conventions which have been duly ratified by Parliament, enter into force automatically, and without any further procedure form an integral part of the Greek legal system while taking precedence over any conflicting legislative provision, pursuant to Article 28(1) of the Constitution. Given the important role that the rules of public international law play today, not only in intrastate relations but also in interstate dealings (both bilateral and multilateral), the wording of Article 28(1) begs the question whether it could be interpreted to mean that ratified treaties also take precedence over the Constitution as well. While this question as it relates to the freedoms of assembly and association is theoretical—the corresponding rights are defined quite precisely—it is clear that the Constitution cannot be used as a vehicle to negate the right to establish NGOs, if their creation is protected by treaties already ratified by Greece.

To measure the compatibility of Constitutional provisions protecting fundamental freedoms to international human rights standards, one could make use of two modes. The first is the domestic one: the competent State organs, principally the courts of justice, rule on the compatibility. The second is the external or multilateral one: judicial organs or semi-judicial

⁸ Cf. Article 23(1) of the German Constitution, which refers to the establishment of the European Union and stipulates that the changes to the EU founding treaties will lead to the amendment of the Constitution.

⁹ The content of this sub-chapter applies, *mutatis mutandis*, to the English legal system as well.

¹⁰ Greece ratified it by virtue of Act 2462/1997, Official Gazette of the Hellenic Government (FEK) 1997 (Issue) A' (No.) 25.

¹¹ Originally Greece had ratified it under Act 2329/1953, FEK 1953 A' 68. However, the military dictatorship renounced it in 1969 and withdrew from the Council of Europe. It was ratified again under Legislative Decree 53/1974, FEK 1974 A' 256, when Greece acceded anew to the Council of Europe.

entities with an international remit rule on the compatibility—in the case of the ICCPR, the Human Rights Committee; in the case of the ECHR, the European Court of Human Rights (the so-called Strasbourg Court).

Greece has recognized the jurisdiction of both the Human Rights Committee and the Strasbourg Court. Accordingly, once domestic courts have ruled on complaints, these multilateral entities have the right (and the mandate) to determine if the respondent State (Greece) has breached its duties under the relevant treaty. For purposes of these transnational entities, the domestic legal system is unified, so it makes no difference whether the violation stems from actions by a State official (e.g., a judge), an act of Parliament, a ministerial decision or by the Constitution itself. Should the respondent State be found in violation of the respective treaty, it must take all necessary actions to rectify the violation and ensure that it will not recur. The judgment may also entitle the complainant party to compensation (depending on the specific provisions of each treaty).

2. Treaty Provisions

The rights of assembly and association are guaranteed under Article 11 of the ECHR as well as under Articles 21 and 22 of the ICCPR. Their text runs as follows:

ECHR:

Article 11 – Freedom of assembly and association

1. Everyone has the right to freedom of peaceful assembly and to freedom of association with others.
2. No restrictions shall be placed on the exercise of these rights other than such as are prescribed by law and are necessary in a democratic society in the interests of national security or public safety, for the prevention of disorder or crime, for the protection of health or morals or for the protection of the rights and freedoms of others.

ICCPR:

Article 21

The right of peaceful assembly shall be recognized. No restrictions may be placed on the exercise of this right other than those imposed in conformity with the law and which are necessary in a democratic society in the interests of national security or public safety, public order (*ordre public*), the protection of public health or morals or the protection of the rights and freedoms of others.

Article 22

1. Everyone shall have the right to freedom of association with others.
2. No restrictions may be placed on the exercise of this right other than those which are prescribed by law and which are necessary in a democratic society in the interests of national security or public safety, public order (*ordre public*), the protection of public health or morals or the protection of the rights and freedoms of others.

(References to the right to form and to join trade unions as well as to the freedom of association as it applies to the armed forces and to the police have been omitted, because they are outside the ambit of the present article.)

The wording of these two multilateral instruments is almost identical, with the exception that the drafters of the ICCPR separated the right of assembly (Article 21) from the freedom of association (Article 22). In essence, these provisions stipulate that everyone (i.e., not only the citizens of contracting States but anyone who resides in their territory) shall enjoy them with no restrictions other than those expressly stipulated; contracting parties are not allowed to add other limitations. Those States wishing to curb their exercise may do so only by invoking specific restrictions contained in the treaties themselves (e.g. to invoke a domestic state of emergency suspending certain rights and freedoms). But even then, the Human Rights Committee and the European Court of Human Rights, acting as supervisory mechanisms of the ICCPR and the ECHR, are competent to rule on whether the imposed limitations are compatible with their provisions. If they are found to be in violation, the respondent State must correct them, regardless of the consequences in domestic affairs.

Finally, it is of some interest to compare the above clauses with the Universal Declaration on Human Rights (UDHR), which was adopted in December 1948 by the UN General Assembly.¹² The UDHR is not the first multilateral (non-binding) instrument for the protection and promotion of human rights and fundamental freedoms (this honor goes to the American Declaration on the Rights and Duties of Man¹³), but it is the most important one. Over the years, it has immensely influenced not only global and regional human rights conventions but also national Constitutions around the world.¹⁴

Article 20 of the UDHR stipulates that everyone shall have the right to freedom of peaceful assembly and association and that no one shall be compelled to belong to an association.¹⁵ The UDHR thus has a wider scope than the ECHR and the ICCPR; it does not include the limitations envisaged in the ECHR and the ICCPR. Further, in stipulating that a State cannot force the population to participate in specific associations, the UDHR again differs from the ECHR and the ICCPR. Under the UDHR, for example, a state could not establish a single environmental NGO and require all citizens who wish to work on environmental issues to join it.

C. Greek Civil Code

In Greece, NGOs are formed as various legal vehicles under the Civil Code, which largely match the types of organizations established by the Civil Codes of other European

¹² General Assembly Resolution 217 A (III) of 10 December 1948. There are currently 438 different translations of the UDHR, see <http://www.ohchr.org/EN/UDHR/Pages/Introduction.aspx>

¹³ Adopted by the Ninth International Conference of American States in April 1948, see <http://www.cidh.oas.org/Basicos/English/Basic2.american%20Declaration.htm>

¹⁴ See H. Hannum, "The Status of the Universal Declaration of Human Rights in National and International Law" [1995-96] 25 *Georgia Journal of International & Comparative Law* 287.

¹⁵ Arguably the corresponding provisions in the American Declaration of the Rights and Duties of Man (Article XXI and Article XXII) were more eloquently drafted, as they talked about the right to assemble "in connection with matters of common interest of any nature" and the right of association as a manifestation of protecting one's "legitimate interests of a political, economic, religious, social, cultural, professional, labor union or other nature."

states.¹⁶ Four forms of organization are relevant: societies or associations (*somateio*); associations of individuals pursuing a specific purpose but not regarded as societies or associations; foundations (*idryma*); and civic non-profit companies or corporations (*astiki mi kerdoskopiki etaireia*).

1. Society or Association

Based on empirical research, societies or associations are the most common legal vehicle employed to set up NGOs in Greece. A lot of the stipulations affecting a *somateio* center on the court system. The procedure to establish them is straightforward and relatively inexpensive. Under Article 79 of the Civil Code, the founders or the persons entrusted with its administration must apply for registration with the Court of First Instance in whose jurisdiction the seat of the *somateio* will be located. The application, which need not be notarized,¹⁷ must be accompanied by the organization's constitutive instrument. The instrument must be in writing, in compliance with the requirement in Article 63 of the Civil Code that the charters or statutes of all legal persons be drawn up in writing. Under Article 78 of the Civil Code, the organization acquires legal personality once it has been entered into the relevant court registry. On the whole, courts enter organizations in these registries without closely examining their constitutive instrument. Indeed, registration is rarely refused and it is a more or less rubber stamp procedure. When it is refused, the founders can seek review before the competent court of justice and upon appeal the case could be heard by Areios Pagos, the highest civil court in the country.

The Civil Code regulates a *somateio* extensively.¹⁸ The regulations take precedence over provisions of the organization's constitutive instrument. For example, under Article 88(2) of the Civil Code, members who believe that they have been improperly expelled from the organization are entitled to file within two months a judicial review of the expulsion before the competent court of justice¹⁹. In addition, the legality of any decision adopted by the assembly of members may be challenged again before the competent court by anyone with a legitimate interest, including those members who dissented from the decision, within six months of the decision's adoption. Under Article 101 of the Civil Code, further, if the court of justice voids the decision, the ruling affects all members, not just those who had contested its legality. Finally, Article 89 of the Civil Code proclaims the equality of all members participating in a *somateio*. Additional rights may be conferred on specific members only if the totality of members consents, acting through the assembly.

¹⁶ The Greek Civil Code entered into force in February 1946. It was considerably influenced by the German Civil Code (Bürgerliches Gesetzbuch - BGB), originally adopted in the 19th century. Subsequent revisions in the Greek Civil Code were also influenced by the BGB.

¹⁷ By contrast, commercial companies which operate as *sociétés anonymes* or as companies with limited responsibility must have the constitutive (founding) instrument or charter drawn up by a notary public. Greek commercial law was influenced by French law, although nowadays there is a large corpus of European Union law in this area.

¹⁸ See Articles 78 to 106 of the Civil Code.

¹⁹ Invariably this will be the court of first instance in whose jurisdiction the NGO has its registered seat.

2. Organizations of Individuals Not Regarded as Societies or Associations

The second type of legal vehicle is envisaged in Article 107 of the Civil Code: organizations which are composed of individuals (i.e. natural persons) drawn together to pursue a specific purpose but which are not regarded as societies or associations. Such entities are obliged to have their constitutive instrument in writing. The Civil Code does not contain any further provisions on this type of legal vehicle other than to stipulate that its provisions dealing with companies or corporations (*etairia*) shall apply by analogy.²⁰

3. Foundations

Article 108 of the Civil Code defines a foundation (*idryma*) in the following terms: if, by virtue of a founding act, property (estate) was designated to serve a specific purpose, the foundation will acquire legal personality by virtue of a presidential decree approving its establishment. If the act creating the foundation takes the form of a legal transaction while the owner of the property is alive, then under Article 109 of the Civil Code, the transaction must be a legal document drawn up by a notary public.²¹ Foundations, as opposed to *somateio*, have no members and, accordingly, no general assembly. An *idryma* is run by its administration.

(It should be noted that, over and above the *idryma*, the Greek legal system acknowledges the existence of another vehicle, the *koinofeles idryma*, which largely corresponds to the English institution of “charity”, at least as far as the notion of charitable purpose or goals is concerned. By contrast to a Civil Code *idryma*, a *koinofeles idryma* does not serve a private aim or purpose. Rather, its fundamental aim is to be “charitable”, a term that includes religious and philanthropic purposes and, generally, any goal which is for the benefit of the public at large. This type of organization is regulated by special legislation.²²)

The requirement of a presidential decree to set up an *idryma* demonstrates that compared to the other legal entities that can be used for establishing NGOs, foundations are subject to heavier intervention by the state. Unlike laws which are deliberated in Parliament, agreed by Parliament and promulgated by the President of the Hellenic Republic (the proper name of Greece),²³ presidential decrees must be signed by the President, reviewed by the Council of State (the highest-ranking administrative court in the country), and then issued by the competent ministers.²⁴ The Council of State, when exercising its advisory role, can recommend to the competent ministers not to proceed because, for example, clauses in the foundation’s constitutive instrument violate the legislation or go against morality (*bonos mores*).

The State, however, does not have absolute discretion. If it refuses the creation of a foundation, it must give proper reasons. The founders can seek review by the courts by arguing

²⁰ See Articles 741 to 784 of the Civil Code.

²¹ Note that a foundation can also be set up by a will. In this case, the legal form of the will must follow the relevant stipulations of the Civil Code. Generally, see K. Magliveras, “The Greek Law of Succession,” in D. Hayton (ed.), *European Succession Laws* (3d ed.) (Bristol: Jordans, 2002), 271.

²² Until the promulgation of Act 4182/2013 (FEK 2013 A’ 185), which has been amended by Article 32 of Act 4223/2013 (FEK 2013 A’ 287), it was regulated by virtue of Act 2039/1939.

²³ See Article 42 of the Constitution.

²⁴ See Article 43 of the Constitution.

that the refusal violates the rights conferred by the Greek Constitution and ratified international treaties. In this instance, the competent court will be the Council of State, which will rule on whether the grounds furnished by the State are valid. By the same token, if the presidential decree has been issued, any other person who can show a legitimate interest in the case can apply for its annulment before the Council of State.

A foundation can also be dissolved by a presidential decree, under Article 118 of the Civil Code, in the following three broad situations: (a) when its aim has already been attained or has become unattainable; (b) when the foundation has deviated from its stated aim; (c) or when its operation is immoral or violates the applicable laws or breaches public order.

In some respects, Greece regulates foundations differently from other European countries. The WWF²⁵ supplies an illustration. WWF was registered as a foundation (*fondation*, *Stiftung*) in Switzerland in 1961, pursuant to Articles 80 et seq. of the Swiss Civil Code.²⁶ In Greece, a WWF International Program Office was created in 1991 under the name Global Fund for Nature—WWF Greece. Three years later, the Greek national organization was established with the legal status of a charitable foundation. Its statute was ratified by the Presidential Decree of January 11, 1994.²⁷ It was then amended by the Presidential Decree of June 5, 2001,²⁸ and by Article 18 of Act 2443/1996.²⁹

Even though an *idryma* and a *fondation* are essentially the same legal vehicle, their regulation differs in a number of respects.³⁰ Article 84 of the Swiss Civil Code stresses the role played by the supervisory authority, which has to be a public law entity operating at the level of the Confederation, a canton, or a commune. The supervisory authority, which is determined according to the goals of the foundation, ensures, inter alia, that the resources given to the *fondation* are used for the intended purposes with no deviation. Under Article 88, moreover, the supervisory authority can dissolve a *fondation* on its own, without applying to a court for a dissolution order, if it deems that the organization's objectives have become unattainable and cannot be maintained by modifying its constitutive instrument or that its objectives have become unlawful or immoral.³¹ Additional requirements can depend on whether the competent body is at the level of the Confederation or of a canton. For example, the Federal Supervisory Board for foundations requires a minimum initial capital of 50,000 Swiss francs (about 49,000 Euro).³² Another notable difference is that whereas Greek foundations have a single mandatory organ,

²⁵ WWF is globally referred to by the abbreviation of its original name, World Wildlife Fund, which was later changed to World Wide Fund for Nature.

²⁶ An official translation of the Swiss Civil Code, which was also influenced by the German Civil Code, is available at www.admin.ch/ch/e/rs/2/210.en.pdf

²⁷ FEK 1994 B' 22 of January 18, 1994.

²⁸ FEK 2001 B' 790 of June 22, 2001.

²⁹ FEK 1996 A' 265 of December 3, 1996. The purpose of this amendment was to exclude it from the provisions of the aforementioned Act 2039/1939 on account of its operational and administrative autonomy.

³⁰ See L. R. Arrivillaga and G. von Schnurbein, "The Swiss Legal Framework on Foundations and Its Principles About Transparency," *International Journal of Not-for-Profit Law*, Vol. 16, no. 1, September 2014, 30.

³¹ See Article 88 of the Swiss Civil Code.

³² Note that since July 1, 1999, all *fondations* must be entered in an electronic registry, which is open and available to the public (<http://www.edi.admin.ch/esv/05263/index.html?lang=de>).

Swiss foundations have two: the council (the supreme governing body) and the board of trustees (audit board); the latter appoints the external auditors.

4. Civic Not-for-Profit Organizations

Articles 741 et seq. address the fourth type of legal vehicle envisaged in the Greek Civil Code, civic not-for-profit companies, corporations, and organizations. These are entities set up by at least two natural persons or legal persons who make joint contributions and commitments to carry out a particular social or economic aim. The founders of NGOs have often used the *astiki mi kerdoskopiki etaireia* to pursue philanthropic aims.

Given the wide-ranging scope of the type of entity, it has also been used for a variety of other purposes and activities, including commercial and scientific. In addition, the Greek government has used these vehicles for programs financed by the European Community and the European Union and undertaken by different legal entities. Article 8 of Act 2372/1996, “Establishment of operators to accelerate the development process and other provisions,” requires the formation of civic not-for-profit companies for those seeking to implement EC- and EU-financed programs dealing with, among other things, the economic and social inclusion of less privileged groups.³³ Arguably, these companies do not meet the criteria of an NGO.

5. NGOs as Legal Persons

Finally, it should be clarified that the Greek Civil Code treats societies and associations as well as foundations as legal persons in order to distinguish them from the natural persons who act as their founders or members.³⁴ The Civil Code does not seem to allow the organizations to participate in other legal persons, whether new or preexisting. Article 62 stipulates: “The capacity of a legal person does not extend to legal relationships, which require the faculty/status of a natural person.” Thus, legal persons do not have the capacity to establish other legal persons even in collaboration with natural persons.

III. NGOs in the English Legal Order

England has a long and distinguished tradition in NGOs. It can boast of many important and successful NGOs, and a good share of them are active on the international plane. Philanthropy is deeply rooted in the Anglo-Saxon world, which has no doubt contributed considerably to establishing NGOs as a trusted institution in England.³⁵ The creation of the Oxford Committee for Famine Relief in 1942 marked a fresh way of looking after the interests of those most in need, irrespective of the country where they are located. Initially the Oxford Committee, which is now internationally known as Oxfam, aimed at ensuring the supply of vital relief to civilians in European countries occupied by the Axis powers during World War II, principally Belgium and Greece. Today, Oxfam, as an international confederation comprising 17

³³ FEK 1996 Issue A’ 29 of February 28, 1996. The Act is apparently still in force.

³⁴ Note that the provisions examined here form part of the third chapter of the Civil Code, which is titled “Legal Persons.” The legal provisions on natural persons (individuals) are contained in the second chapter of the Civil Code.

³⁵ Generally, see W.K. Jordan, *Philanthropy in England, 1480-1660: A Study of the Changing Pattern of English Social Aspirations* (London: G. Allen & Unwin, 1959).

organizations,³⁶ is active in more than 90 countries and works alongside local partners.³⁷ Its main objectives are to address the root causes of poverty and to respond to humanitarian emergencies.³⁸

Oxfam considers itself part of the so-called “non-profit sector.” It is one of the signatories of the INGO (international nongovernmental organization) Accountability Charter, which was concluded in 2005 and further developed in 2014 as a voluntary commitment to high standards of transparency, accountability, and effectiveness.³⁹

At the same time, Oxfam is a registered charity in England and Wales as well as in Scotland. The notion of a “registered charity” denotes that an organization with charitable purposes and aims is under the supervision of the Charity Commission (if registered in England and Wales) or the Office of the Scottish Charity Regulator (if registered in Scotland). Since these two entities operate as “non-Ministerial Government Departments,” they form part of the wider public administration system in Great Britain. Even so, they are completely independent of ministerial influence. To that extent, they can be considered as regulatory authorities enjoying budgetary and administrative independence. These two entities act under the principal legislative instruments covering “charities”: the Charities Act 2011 (England and Wales) and the Charities and Trustee Investment (Scotland) Act 2005.⁴⁰

The Charities Act 2011, which came into effect on March 14, 2012, sets out how charities in England and in Wales are to be registered and regulated. According to section 1 of the Charities Act 2011,⁴¹ “charity” means an institution that meets the following two conditions: first, it has been established for charitable purposes only; and second, it falls into the ambit of the control of the High Court.⁴² What constitutes “charitable purposes” is laid down in sections 2 and 3 of the Charities Act 2011:

- (a) the prevention or relief of poverty;
- (b) the advancement of education;

³⁶ Most of these organizations are in countries of the so-called First World and not in the countries where Oxfam implements its programs: Oxfam America; Oxfam Australia; Oxfam-in-Belgium; Oxfam Canada; Oxfam France; Oxfam Germany; Oxfam Great Britain; Oxfam Hong Kong; Oxfam India; Oxfam Intermón (Spain); Oxfam Ireland; Oxfam Mexico; Oxfam New Zealand; Oxfam Novib (Netherlands); Oxfam-Québec; Oxfam Italy; and Oxfam Japan.

³⁷ For the list of countries, see <http://www.oxfam.org.uk/what-we-do/countries-we-work-in>.

³⁸ For the current Oxfam Strategic Plan (2013-2019), which is titled “The Power of People Against Poverty,” see <http://www.oxfam.org/en/about/accountability/oxfam-strategic-plan-2013-2019>.

³⁹ For the current text of the Accountability Charter, see http://www.ingoaccountabilitycharter.org/wpcms/wp-content/uploads/INGO_CHARTER_web.pdf.

⁴⁰ It should be noted that even though the United Kingdom of Great Britain and Northern Ireland is a unitary State, there exist three separate legal regimes covering, respectively, England and Wales, Scotland, and Northern Ireland. This divergence of legislation also applies in the case of regulating charities. For purposes of convenience only the provisions of the Charities Act 2011 will be examined here.

⁴¹ Note that the English legislation is broken down into “sections” and not into “articles,” as is the case with Continental European legislation.

⁴² The High Court (the full title is “Her Majesty’s High Court of Justice in England”) is one of the senior British courts with territorial jurisdiction in England and Wales. Its principal function is to consider important legal cases. But it has also been endowed with other juridical tasks.

- (c) the advancement of religion;
- (d) the advancement of health or the saving of lives;
- (e) the advancement of citizenship or community development;
- (f) the advancement of the arts, culture, heritage or science;
- (g) the advancement of amateur sport;
- (h) the advancement of human rights, conflict resolution or the promotion of religious or racial harmony or equality and diversity;
- (i) the advancement of environmental protection;
- (j) the relief of those in need because of youth, age, ill-health, disability, financial hardship or other disadvantage;
- (k) the advancement of animal welfare;
- (l) the promotion of the efficiency of the armed forces of the Crown or of the efficiency of the police, fire and rescue services or ambulance services; and
- (m) any other aim, which may reasonably be regarded as analogous to any aims falling within any of above (a) to (l).⁴³

If one were to argue that some of the above should not be regarded as activities usually promoted by NGOs (e.g., the advancement of citizenship or the promotion of the efficiency of the British armed forces), it should be remembered that “charity” in the English legislation has a specialized meaning.⁴⁴

Section 2 of the Charities Act 2011 stipulates that all activities must be “for the public benefit,” a term not expressly defined in the legislation but rather left to be interpreted by the Charity Commission. Thus, the Charity Commission has described the term “public benefit” as follows:

Public benefit is an essential part of what it is to be a charity. But it is not just a legal requirement that charities have to meet and that we regulate. It also provides charities with a positive opportunity to demonstrate the benefits they bring to the public, in return for the financial and other benefits that come from being a charity, such as public support.⁴⁵

Moreover, it has acknowledged that there can be no precise definition of “public benefit.” Rather, it must be examined on a case-by-case basis.⁴⁶

⁴³ For analysis, see J. Garton, *The Regulation of Organised Civil Society* (Oxford: Hart Publishing, 2009), 147-154.

⁴⁴ See N. Malik, “Defining ‘Charity’ and ‘Charitable Purposes’ in the United Kingdom,” *International Journal of Not-for-Profit Law*, Volume 11, Issue 1, November 2008, available at http://www.icnl.org/research/journal/vol11iss1/special_2.htm.

⁴⁵ See Charity Commission, *Public Benefit: An Overview*, September 2013, 3, available at http://www.charitycommission.gov.uk/media/535041/public_benefit_an_overview.pdf.

⁴⁶ See Charity Commission, *Analysis of the Law Relating to Public Benefit*, September 2013, available at <http://www.charitycommission.gov.uk/media/94849/lawpb1208.pdf>.

Pursuant to section 30 of the Charities Act 2011, every charity must be entered in the register kept by the Charity Commission,⁴⁷ except for those whose annual gross income does not exceed GBP 5,000 (about 6,500 Euro). Section 37 stipulates that an institution is conclusively presumed to be a charity when it appears on the register. Registered charities must reveal their total income. Larger charities must also submit a financial profile disclosing, inter alia, their long- and short-term investments.

IV. Conclusions

Greece and England have followed different models for the regulation of NGOs. Greece has de facto allowed individuals to endow their organizations with legal personality by using the private law entities envisaged in the Civil Code (other than commercial enterprises and companies), but so far it has not drafted a regulatory framework specific to NGOs. In England, by contrast, the longstanding existence of charities, as a separate and regulated legal entity, arguably obviated the need for NGO-specific legislation. Any interested NGO could become a registered charity, so long as its activities fell within the broadly worded permissible purposes, and gain the advantages that this status entails.

Lacking the legal category of “charity,” Greece ought to adopt a regulatory framework tailored to the ever increasing number of NGOs. The ordinary operation of the very large number of NGOs currently active in Greece demands the existence of a framework, which would not have to be elaborate. It will be submitted that small changes to the Civil Code would allow adding NGOs as another tailor-made legal vehicle available to individuals seeking to pursue their legitimate interests together, especially interests that are protected by the Constitution. The Civil Code ought to recognize the NGO as a separate entity with legal personality, distinct from the other legal vehicles.

In particular, the Civil Code ought to allow a group of individuals, regardless of citizenship (i.e. both Greek citizens and aliens), to set up a legal person specifically categorized as a “nongovernmental organization” and enjoying full juridical personality, separate from associations, (charitable) foundations, and not-for profit undertakings. As for regulatory details, the Civil Code could stipulate that the elaborate provisions on associations (*somateio*) will apply by analogy.

In Greece, as in other Continental European countries, the codification of rules and custom is a guiding principle of the legal culture. Civil Codes, as the principal regulatory instrument governing private-to-private dealings and transactions, should keep pace with societal changes and trends. There is no doubt that the establishment and operation of thousands of NGOs in Greece in the past 25 years has been such a trend. England, having no such tradition in codification, has perhaps been more flexible by adopting purposely-drafted legislation whenever the need arose.

Arguably, the Greek Civil Code has been allowed to lag behind societal developments. The last overhaul concerned family law and took place in the early 1980s. The addition of NGOs to the list of legal vehicles in the Civil Code will offer a tailor-made entity to those wishing to exercise their freedom of association. It will also increase the number of international NGOs operating on Greek territory.

⁴⁷ The Register of Charities is available at <http://www.charitycommission.gov.uk/find-charities>.

One author has described the power of the NGOs in the following terms:

As norm entrepreneurs, [NGOs] advocate substantive constitutional principles, human rights, the rule of law and democracy. Furthermore, NGOs strengthen these principles in situations where state organs or agencies fail to fulfil their essential functions and, in exceptional situations, even act as surrogates of state officials where state institutions have broken down.⁴⁸

A type of organization that might have the potential to play such an instrumental role cannot be left without customized regulation, especially in today's Greece, where traditional legal principles such as the rule of law have arguably been traumatized while the enemies of the rule of law such as corruption have become the order of the day. Although proper regulations cannot guarantee that NGOs will successfully take over where the State has failed, segments in society expect them to pursue the wider good.

Finally, it is high time that Greece harmonized its Constitution with EU law and institutions. The Constitution ought to state clearly that the rights guaranteed by Articles 11 and 12 extend to the citizens of all EU member states, rather than, as now, only to Greek nationals. England, lacking a written Constitution, has not had to face this issue.

These are urgent issues that must be addressed. The sooner they are dealt with, the greater the benefits that NGOs and their members can confer on Greek society.

⁴⁸ T. Kleinlein, "Non-State Actors from an International Constitutionalist Perspective: Participation Matters!" in J. d'Aspremont (ed.), *Participants in the International Legal System. Multiple Perspectives on Non-State Actors in International Law* (Abingdon: Routledge, 2011), 41, 44.

Article

A FRAMEWORK FOR ANALYSIS OF ISLAMIC ENDOWMENT (WAQF) LAWS

MOHAMMED OBAIDULLAH, PH.D.¹

Analysis of the Shariah-legal framework for Islamic endowments (awqaf, or in singular waqf) around the globe reveals that the Shariah law as well as the national laws are rooted in several considerations. Preservation of the endowed assets seems to be the overriding consideration, which has been interpreted variously as preservation of the assets in their physical form and as preservation of benefits for the intended beneficiaries. While preservation of assets manifests in the form of stipulations such as prohibitions against any sale, gift, or mortgage that might lead to transfer of ownership of the assets, preservation of benefits for the intended beneficiaries requires prudent management of the assets and efficiency in their development and investment. Development may actually lead to expansion of benefits for the intended beneficiaries and may at times require a degree of dilution in the stipulations concerning preservation. We find that laws and regulations often involve a trade-off between concerns about preservation of assets in physical form and concerns about development. Although the focus here is on Islamic endowments in India, this framework may also be employed to analyze laws in other jurisdictions.

1. Introduction

Laws governing Islamic endowments (*awqaf*, or in singular *waqf*) display wide variations. In most countries the laws demonstrate the influence of their colonial past. In these countries, Islamic law was superseded by secular law² and the endowments remained dormant for long periods. The extent of reform efforts varies among countries. For example, though Malaysia is far ahead of others in putting into practice Islamic law in the field of banking, insurance, and financial markets, it lags way behind in operationalizing a progressive law for its *awqaf* sector. Indonesia stands far ahead of others in enacting a law that reflects state-of-the-art thinking among scholars in the field and that may perhaps serve as a model for other countries. India, Pakistan, and Bangladesh share the same origin, in laws enacted during the undivided British India, but they have introduced reforms in varying degrees since achieving their independence. A high degree of commonality therefore exists in their laws.³

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² Islamic law was replaced by British law in all countries with the exception of Indonesia, which was colonized by the Dutch.

³ See *Islamic Social Finance Report* (2014), ch. 4, Islamic Research and Training Institute, Jeddah, Saudi Arabia, which provides a comparative analysis of regulations for the *awqaf* sector in six countries in South and Southeast Asia.

Malaysia comprises thirteen states and federal territories. In Selangor and Malacca, the provisions of law on *awqaf* are provided under the Enactment of Wakaf (State of Selangor) 1999 and the Enactment of Wakaf (state of Malacca) 2005; the other states that do not have such legislation are governed by the states' administration of Islamic law.⁴ The provisions of Part VI of the Administration of the Religion of Islam (Federal Territories) Act 1993 relating to Islamic endowments have striking similarities with those in Chapter 3 of the Administration of Muslim Law Act, Singapore 1999, that deal with Islamic endowments.

In Indonesia, *waqf* is regulated by the Act of Republic of Indonesia No. 41 on Waqf 2004.

India, Pakistan, and Bangladesh share a common history of being part of the undivided India ruled by the British until 1947; therefore, they show striking similarities in their *waqf* laws.⁵ There have been major changes since, though. India, like its neighbors, has a long history of *waqf* laws in various versions, including the Waqf Act 1995 followed by the Waqf Reform Act 2013, which may be the most recent applicable legislation in any country. In Pakistan the Provisional Waqf Ordinances 1979 in its four provinces provide the regulatory framework. In Bangladesh the Waqf's Ordinance 1962 primarily governs *waqf* creation and administration.

In the Gulf Cooperation Council and Middle East/North Africa region, laws governing Islamic endowments have also evolved over time. Islamic endowments were transferred from the voluntary sector (managed by private trustees under the supervision of the *qadi*/judiciary) into the domain of the governments as a response to alleged corrupt practices and usurpation. The endowments in the region remain under the control of the Ministry of Islamic/Religious Affairs.

State control has been less stringent in Sub-Saharan Africa. Countries such as Nigeria and Sudan have been giving increasing attention to reforming their *waqf* infrastructure and providing an enabling regulatory environment for the endowments to be managed and developed.

Analysis of the Shariah-legal framework for Islamic endowments around the globe reveals that the Shariah law as well as the national laws of *awqaf* are rooted in several considerations. Preservation of the endowed assets seems to be the overriding consideration, which has been interpreted variously as preservation of the assets in their physical form and as preservation of benefits for the intended beneficiaries.⁶ While preservation of assets manifests in the form of stipulations such as prohibitions against any sale, gift, or mortgage that might lead to transfer of ownership of the *waqf* assets, preservation of benefits for the intended beneficiaries requires prudent management of the assets and efficiency in their development and investment. Development may actually lead to expansion of benefits for the intended beneficiaries and may at times require a degree of dilution in the stipulations concerning preservation.

In the next section, we present a framework for analysis of laws and regulations as they have been put in place over time. We demonstrate that these have often involved a trade-off between concerns about preservation of assets in physical form and concerns about development.

⁴ The term *wakaf* is used for Islamic endowments in Southeast Asian countries, including Malaysia. The corresponding term in South Asia is *wakf*; in the Middle East, *waqf*; and in North Africa, *habs*.

⁵ This is also the case with Zanzibar in Tanzania that was under British occupation.

⁶ See Monzer Kahf, *Towards the Revival of Awqaf: A Few Fiqhi Issues to Reconsider*, paper presented at Harvard Forum on Islamic Finance and Economics, October 1, 1999, Harvard University, U.S.A.

Using the framework, we analyze laws of Islamic endowments as they have evolved in India. Based on the analysis we argue that further reforms are required to facilitate creation of new endowments and revival of existing endowments.

2. Understanding the Regulatory Trajectory

In order to appreciate the way the laws have evolved over time, we present the concept of society's objective function for laws/regulations/rules/policies. We hypothesize that the objective function for laws/regulations/rules/policies pertaining to Islamic endowments is determined largely by the Islamic scholars who lead the Muslim masses in matters of religion. In a democratic state the laws seek to capture the objective function over time. We hypothesize that given the large-scale encroachment of *awqaf* assets by rulers, the scholars' and society's primary objective has been the preservation of assets. However, over time one may witness a shift in the objective function from (i) preservation of assets to (ii) preservation of benefits for the intended beneficiaries and vice-versa. For instance, such a shift in the objective function is believed to have taken place as one finds increasing scholarly discussion of the concepts of exchange and replacement of waqf assets (*ibdal* and *istibdal*). Arguably, this may occur in the face of a realization that the objective function may need to be modified to (iii) sustained enhancement of benefits for the intended beneficiaries. This would also ensure the fulfillment of (i) and (ii).

Society's objective function may be presented in a two-dimensional space as Regulatory Efficiency Frontier (REF), with the two dimensions being preservation and development. Creation of an enabling legal environment would involve a search for laws of the following types:

1. Laws that enhance both preservation and development: a movement toward the Regulatory Efficiency Frontier
2. Laws that enhance preservation without adversely affecting development: a vertical move upward
3. Laws that enhance development without adversely affecting preservation: a horizontal move to the right

The search for efficiency should involve movement of all three types. Society will optimize efficiency gains at the Regulatory Efficiency Frontier (see Figure 1). A shift in objective function itself (relative importance attached to concerns about preservation and development) would mean a change in the shape of the REF.

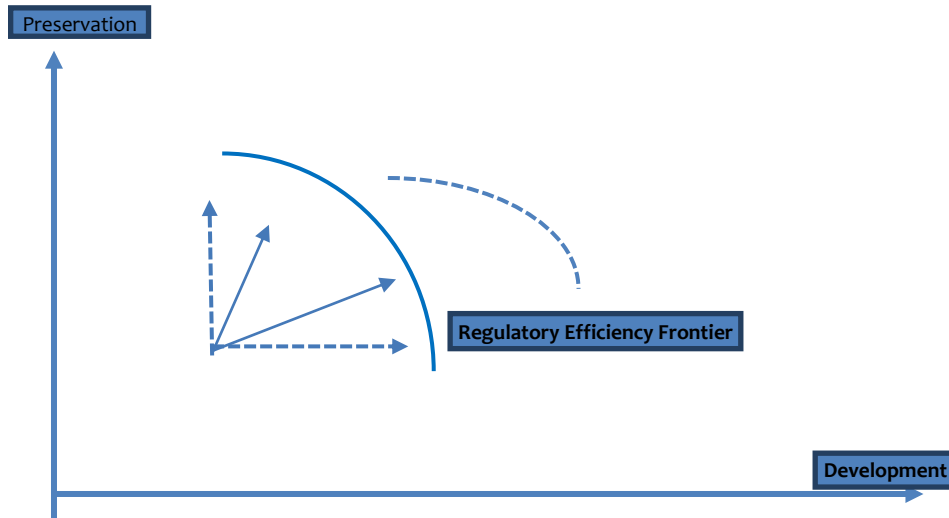
3. Islamic Endowments in India

The following facts for the Indian *awqaf* sector provide the basis for the framework. The size of assets under Islamic endowments in India is huge. The Report on Social, Economic and Educational Status of the Muslim Community of India (2006) estimated that there are more than 490,000 registered Islamic endowments.⁷ The total area under endowed land assets is estimated at 600,000 acres; 80 percent is in rural India and the rest is in major cities. The book value of these assets is estimated at USD 1 billion and the market value at USD 20 billion. At the same

⁷ Social, Economic and Educational Status of the Muslim Community of India: A Report, Prime Minister's High Level Committee, Cabinet Secretariat Government of India, November, 2006, http://www.minorityaffairs.gov.in/sites/upload_files/moma/files/pdfs/sachar_comm.pdf

time, the annual income on endowed assets is meager, estimated at USD 27 million, or 2.7 percent of book value.

Figure 1: Regulatory Efficiency Frontier



The Islamic endowments in India are characterized by massive encroachment by state agencies and corporate entities, raising serious concerns of preservation. Historians assert that aggressive encroachment by the state began after the 1857 mutiny against the British raj. According to one estimate, currently in Delhi alone, over 30 percent of about 2,000 *waqf* properties are illegally occupied by government agencies. Media reports on high-profile cases have kept the concerns about preservation on the front burner. For example, in 2002 an orphanage land valued at about USD 24 million was sold for USD 3.4 million for construction of the residence of India's richest man (currently valued at around USD 1 billion).⁸

Studies have also reported excellent returns on properties post-development. Therefore, it is believed that the potential and significance of *development* is huge. A study by Syed Khalid Rashid estimated the average return on investment of 20 percent post-development.⁹

3.1. *Waqf* Laws in India

India has witnessed multiple *waqf* laws beginning in 1810. The more recent enactments have been the Wakf Act 1954, Wakf Amendment Act 1984, Wakf Act 1995, and now the Wakf Amendment Act 2013.

A research study undertaken by Hasanuddin Ahmad and Ahmadullah Khan in 1995 for the Islamic Research and Training Institute (IRTI) provides the complete history of *waqf* laws in

⁸ "Mukesh Ambani, India's richest man, faces court over Dh3.6bn Mumbai home," The National, Aug. 4, 2011, <http://www.thenational.ae/news/world/south-asia/mukesh-ambani-indias-richest-man-faces-court-over-dh3-6bn-mumbai-home#ixzz3Eb2rfPxx>.

⁹ S.K Rashid (2005), Protection, Maintenance and Development of Awqaf in India (with special reference to Rajasthan), Institute of Objective Studies, New Delhi, pp 74-85.

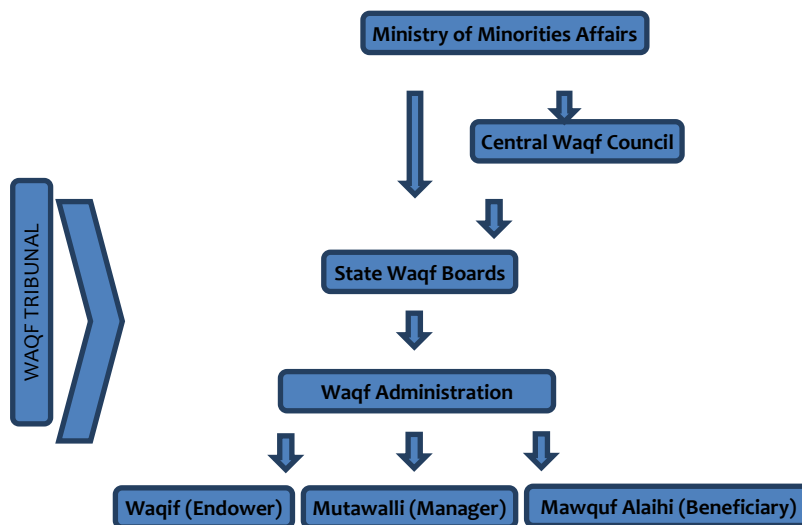
India.¹⁰ However, we restrict our analysis to post-independence India where laws resulted from the democratic process rather than British rule. The first comprehensive legislation for *waqf* in independent India was the Waqf Act 1954. However, this Act failed to address the concerns relating to *awqaf*; therefore, a Waqf Enquiry Committee was constituted by the government in 1969 comprising public representatives. The Committee held nationwide deliberations and made wide-ranging recommendations. This led to the passage of the Waqf Amendment Act 1984. However, for a variety of reasons, this Act remained dormant. The Waqf Act 1995 is the first comprehensive piece of law that defined the rules of the game. The operation of the law, however, continued to attract criticism, and it was largely perceived to be ineffective in preserving the *waqf* assets. This led to further calls for reform. The Waqf Reform Bill 2010 was formulated after extensive consultations. It took the shape of Waqf Amendment Act 2013 three years later.

We focus on provisions of the Waqf Act 1995 and the Waqf Amendment Act 2013 and highlight how the changes that have taken place over time with respect to the infrastructure for *waqf* administration address the concerns about preservation and development.

3.2. Waqf Infrastructure

India has a huge *waqf* infrastructure under its Ministry of Minorities Affairs, but with significant autonomy to *waqf* boards constituted at the provincial or state levels. The State Waqf Boards (SWBs) are established by the respective provincial or state governments in view of sections 13 and 14 of the Wakf Act 1995. These work towards management, regulation, and protection of the *waqf* properties by constituting local committees. Currently there are thirty *waqf* boards across the country. The Central Waqf Council is a statutory body established in 1964 by the Government of India under Wakf Act 1954 (now a subsection the Wakf Act 1995) for the purpose of advising it on matters pertaining to working of the State Waqf Boards and proper administration of the *awqaf* in the country.

Figure 2. Waqf infrastructure in India



¹⁰ Hasanuddin Ahmad and Ahmadullah Khan (1995), *Strategies to Develop Waqf Administration in India*, Islamic Research and Training Institute, Jeddah, Saudi Arabia.

Figure 2 presents the various components of the *waqf* related infrastructure in India.

We move on to explore how changes in laws over time affecting them have been governed by concerns about preservation and development.

3.2.1. Central Waqf Council

Section 9-12 of the Wakf Act 1995 provided for the creation and functions of the CWC to advise the Government of India on matters concerning the working of Waqf Boards and the due administration of *awqaf* in the country; and to undertake development of *waqf* assets to ensure preservation.

These provisions were clearly governed by a need to ensure physical preservation of endowed assets (movement of type 2 towards REF in Figure 1). The Act asserted that the endowed assets need to be developed lest they be physically dilapidated to an extent that they would cease to provide any benefits. Thus, the focus was on maintenance of the assets so that benefits continued to flow out and not on development of the assets so that benefits could be enhanced. The law at this stage provided very little that could lead to large-scale development of the endowed assets.

The Waqf Amendment Act 2013 sought to strengthen the role of the CWC as a central and key pillar in *waqf* administration. Among other things, it sought to address the concerns about physical preservation of endowed assets (movement of type 2 toward REF) by empowering the CWC to issue directives to the State Waqf Boards (SWBs) on their financial performance, survey, and maintenance of *waqf* deeds, revenue records, and encroachment of *waqf* properties seeking annual report and audit report; and by providing for any disputes arising out of its directives to be referred to a high-level Board of Adjudication

3.2.2. State Waqf Boards

The idea of federalism, with the State Waqf Boards (SWBs) as the foremost actors in *waqf* administration in India, was introduced quite early. However, it was the Wakf Act 1995 that provided an elaborate list of power and functions of the SWBs (Section 32) as well as the duties and obligations for the trustee-manager or *mutawalli* relating to registration, disclosure, and compliance with directives of the board (Section 50). These provisions were essentially governed by the concern to ensure and enhance preservation of the endowed assets (movement of type 2 towards REF).

Section 32.2 describes the powers and functions of the SWBs as follows:

1. to maintain a record containing information relating to the origin, income, object, and beneficiaries of every *waqf*;
2. to ensure that the income and other property of *awqaf* are applied to the objects and for the purposes for which such *awqaf* were intended or created;
3. to give directions for the administration of *awqaf*;
4. to settle schemes of management for a *waqf*, provided that no such settlement shall be made without giving affected parties an opportunity of being heard;
5. to direct (i) the utilization of the surplus income of a *waqf* consistent with the objects of *waqf*; (ii) in what manner the income of a *waqf*, the objects of which are not evident from

any written instrument, shall be utilized; (iii) in any case where any object of *waqf* has ceased to exist or has become incapable of achievement, that so much of the income of the *waqf* as was previously applied to that object shall be applied to any other object, which shall be similar to the original object or for the benefit of the poor or for the purpose of promotion of knowledge and learning in the Muslim Community;

6. to scrutinize and approve the budgets submitted by *mutawallis* and to arrange for auditing of account of *awqaf*;
7. to appoint and remove *mutawallis* in accordance with the provisions of this Act;
8. to take measures for the recovery of lost properties of any *waqf*;
9. to institute and defend suits and proceedings relating to *awqaf*;
10. to sanction any transfer of immovable property of a *waqf* by way of sale, gift, mortgage, exchange, or lease;
11. to administer the Waqf Fund;
12. to call for such returns, statistics, accounts, and other information from the *mutawallis* with respect to the *waqf* property as the board may require;
13. to inspect, or cause inspection of, *waqf* properties, accounts, records, or deeds, and documents relating thereto;
14. to investigate and determine the nature and extent of *waqf* and *waqf* property, and to cause, whenever necessary, a survey of such *waqf* property; and
15. generally do all such acts as may be necessary for the control, maintenance, and administration of *awqaf*.

This law also provided for proactive intervention for development of an asset with prior government approval (Section 32.4). The development-related concerns were obviously becoming more significant in shaping the regulatory framework (movement of type 3 towards REF).

Section 32.4 stipulates that where the board is satisfied that any endowed asset offers a feasible potential for development, it may ask the *mutawalli* to develop it. Otherwise, it may, with the prior approval of the Government, take over the asset, develop it with its own funds, and control and manage it until the original investment and the financing cost are recovered (Section 32.5), subsequent to which the developed asset shall be handed over to *mutawalli* of the concerned *waqf* (Section 32.6).

The Waqf Amendment Act 2013 made major changes with respect to the power and functions of the SWBs. It did away with the “government approval” requirement in Section 32.5, thus paving the way for SWBs to undertake development faster and more easily. It also provided for additional physical punishment over and above financial penalties for the *mutawalli* in case of non-compliance with provisions of the law concerning its duties and responsibilities vis-à-vis preservation and development of the endowed assets (movement of type 1 towards REF) (Section 61).

It also sought to strengthen the preservation of endowed assets (movement of type 2 towards REF) by providing for:

- Establishment of boards in states where they are nonexistent (Section 13);
- Prohibition of sale, gift, exchange, mortgage, or transfer of *waqf* property ab initio, except for the possibility of acquisition of *waqf* properties for a public purpose under the Land Acquisition Act 1894 or any other law relating to acquisition of land if the acquisition is made in consultation with the board, provided also that (a) the acquisition shall not be in contravention of the Places of Public Worship (Special Provisions) Act 1991; (b) the purpose for which the land is being acquired shall be undisputedly for a public purpose; (c) no alternative land is available which shall be considered suitable for that purpose; and (d) to safeguard adequately the interest and objective of the *waqf*, the compensation shall be at the prevailing market value or a suitable land with reasonable *solatium* in lieu of the acquired property (Section 51);
- Restoration of *waqf* properties in occupation of government agencies to the *mutawalli* or Waqf Board, or payment of rent at market rates (Section 51);
- Inclusion of professionals and scholars on the board, with a Muslim CEO to effectively deal with administrative machinery in the state (Section 20);
- Removal of corrupt members through no-confidence motion (Section 20A);
- Survey and digitization of records, and compulsory registration within one year of enactment and every ten years thereafter (Section 6); and
- Punishment for alienation of *waqf* assets (Section 52A).

3.2.3. Tribunal

While the dominant role in *waqf* administration is entrusted to the state, the judiciary is expected to act as a watchdog to prevent acts of transgression by the state agency against the *mutawalli* and adjudicate in matters of dispute. However, its effectiveness in ensuring fair play is dependent on provisions of law that define its constitution, power, and functions.

The Waqf Act 1995 provides for establishment of a Waqf Tribunal to adjudicate disputes on whether a particular property is indeed *waqf* property (Sections 6-7) and to ensure fair deal to an aggrieved trustee-manager (Sections 33-35), member (Section 16), and executive officer and staff of SWBs (Section 38.7). However, though the creation of the Tribunal was primarily to ensure the preservation of endowed assets (movement of type 2 towards REF) by recovering encroached assets (Section 52), experience showed that the Tribunal was largely ineffective against encroachment.

The Waqf Amendment Act 2013 sought to further enhance preservation of endowed assets (movement of type 2 towards REF) by providing that the Tribunal has powers of assessment of damages by unauthorized occupation of *waqf* property and to penalize unauthorized occupants and to recover damages; and a public servant who fails in his lawful duty to prevent or remove such an encroachment can be convicted and fined (Section 54).

3.3. Management of Assets

According to Islamic law, it is compulsory to invest *waqf* assets.¹¹ It is the duty of the *mutawalli* to manage the *waqf* assets prudently and efficiently. And it is the duty of the state (*waqf* administration) and judiciary to ensure that the *mutawalli* is complying. The returns or benefits from the endowed assets are meant to flow to the beneficiaries as intended by the endower or *waqif*. However, early lawmakers seemed to be obsessed with the idea of preservation. The Waqf Act 1995 stipulated that the lease or sublease of endowed assets was not permissible for a period beyond three years (movement of type 2 towards REF). Lease or sublease was permitted for one to three years, but only with prior approval of the board (Section 56). Ruling out any long-term lease effectively barred the possibility of participation of return-seeking private capital in the development of *waqf* assets.

This realization has led to amendment of the above restrictive section in the Waqf Amendment Act 2013, which provides the following:

1. The lease period is extended to up to 30 years for commercial activities, education, or health purposes;
2. Approval by the state government is necessary because of the long gestation periods;
3. The board will sanction a lease with the consent of at least two-thirds of members; and
4. The maximum period of lease for agricultural land is three years.

Clauses 2, 3, and 4 show that sufficient caution has been exercised while facilitating the development of endowed assets. The Leasing Rules 2014 further enhance preservation as well as development aspects (movement of type 1 towards REF) by requiring that:

1. The minimum lease rental on such assets put under lease must be at least 5 percent of the market value;
2. Lease rentals must increase by not less than 5 percent every year;
3. There must be competitive bidding;
4. Two years' rent must be paid upfront as security if the lease period is over 10 years;
5. No sublease is permissible;
6. No clause should exist for automatic renewals of the lease; and
7. Stringent conditions must exist in the agreement for possible default by lessee.

The above rules have been formulated by the Ministry of Minority Affairs as prescribed by the Act. Arguably, these need to be revisited.

3.4. Need for Development of Endowed Assets

In line with a growing concern that development is the only way to enhance the benefits for endowment beneficiaries (a flatter REF to the right), there is a need to look at the available mechanisms to ensure development.

¹¹ Resolution No. 140-15/6, Rulings of OIC Fiqh Academy on Awqāf, reproduced in Obaidullah, M. (2013), *Awqaf Development and Management*, Islamic Research and Training Institute, Jeddah, Saudi Arabia, ch. 3.

The mechanism for *waqf* development that has existed for several decades is the Urban Waqf Properties Development Scheme of Central Waqf Council. It is funded through a yearly grant-in-aid from the Central Government. The scheme provides loans with two conditions for *waqf* management: (i) donation of 6 percent per annum to Education Fund, and (ii) 40 percent of enhanced income after loan repayment to be paid towards education.

The National Waqf Development Corporation (NAWADCO) has been set up recently with the explicit objective of development of *awqaf* assets.

3.5. Making Sense of Some Numbers

Against 490,000 registered *awqaf* properties with an estimated market valuation of assets at USD 24 billion, the Urban Waqf Properties Development Scheme of Central Waqf Council has hitherto provided loans to 137 projects of USD 5.77 million (1974-2012), of which 84 have been completed in all respects and are now yielding income; and the National Waqf Development Corporation has been established with authorized capital of INR 500 *crores* (USD 80 million), which is less than 0.35 percent of asset value.

A question therefore arises: How do we meet the massive capital needs for *waqf* development in an efficiency-enhancing manner?

The first mechanism following from successful international experiments seems to be private capital contribution for limited periods. This would, however, call for a relaxation of leasing rules, and more specifically, to allow subleasing to facilitate *sukuk* issues, since no other form of Shariah-compliant borrowing is possible in India. Without permitting subleases, many of the modern *awqaf* financing mechanisms would fall flat.

One may draw here a parallel with the widely acclaimed success in *waqf* development in Singapore by the state agency Majlis Ugama Islam Singapura (MUIS). MUIS has been highly successful in transforming and significantly enhancing the incomes of *awqaf* assets in Singapore. MUIS now manages 68 *waqf* assets directly and an additional 33 *waqf* assets indirectly through *mutawallis*. MUIS appoints *mutawallis* for privately managed *awqaf* and approves any development or redevelopment or purchases by them. It holds the title deeds of all, including the privately managed *awqaf*. Observers attribute this success to a very progressive regulatory change that has allowed leasing *waqf* property for up to 99 years without transferring the ownership to the lessee; and has allowed selling *waqf* properties completely and replacing them with new, higher-yielding free-hold properties (*istibdal*). Because of this flexibility, MUIS could issue participation *sukuk* called Musharaka bonds to finance the development of endowed assets on a fairly large scale.¹²

The second mechanism to finance the development of new *waqf* is through creation of new *waqf*. However, the *waqf* laws in India in their present form do not provide for explicit rules for cash *waqf* and *waqf* shares.

Laws are also silent on rules pertaining to investment of cash *waqf*.

It is a matter of common observation that there is need for level playing field for *awqaf* as compared with other forms of not-for-profit organization, such as societies, trusts, and Section 35

¹² See Shamsiah Bte Abdul Karim (2010), Contemporary *Shari'a* Compliance Structuring for the Development and Management of *Waqf* Assets in Singapore, Kyoto Bulletin of Islamic Area Studies, 3-2.

Companies. However, *waqf* involves significant financial and non-financial costs as compared to the above structures, leading to lack of interest among Muslim philanthropists for using the *awqaf* for establishing of education, healthcare, and other socially useful projects. A striking example is that of Azim Premji Trust, which transferred 295.5 million equity shares, valued at USD 2.3 billion, representing 12 per cent of the shares of Wipro Ltd, to an *irrevocable* trust (the Azim Premji Trust) that finances the activities of the Azim Premji Foundation.¹³ The irrevocability of the trust takes care of the most significant difference between a *waqf* and a trust; therefore, the Azim Premji Trust can be legitimately called an innovative case of corporate *waqf*. There are strikingly similar examples of corporate *waqf*, such as the WANCORP by Johor Corporation in Malaysia and the Vehbi KoC Foundation in Turkey,¹⁴ and there is no reason why Indian laws cannot provide for the possibility of corporate *waqf*.

Interestingly, there is very little mention of the term *waqif* or donor in the Indian *waqf* laws. It appears that these laws are meant for *awqaf* created many centuries ago, not for newly created ones. It is worth considering giving *waqif* an option to create *waqf* outside the purview of board (which is where most non-financial costs come from). Without such changes, the problem of funds will continue to haunt the prospects of *waqf* development.

4. Conclusion

This article traced the trajectory of the laws of *awqaf* in India and examined how different provisions of the laws were enacted to address the societal concerns about preservation of endowed assets with a view to retaining its expected benefits for the intended beneficiaries, or developing the assets with a view to enhancing the expected benefits for the intended beneficiaries. The former seems to have dominated the minds of lawmakers in India so far, though of late there seems to be growing recognition of the significance of the latter. The search for efficiency-enhancing rules must continue. One must not shy away from considering and experimenting with innovations in *waqf* financing, which is essential for taking the development agenda forward. Undoubtedly, it makes no sense to allow the endowed properties to remain as they are, without being of any value or providing benefits to anyone.

Further, the modes to address society's concerns (preservation or development) must be correctly identified. For example, extreme concern for preservation has led to seeking state protection without recognizing its adverse impact on the institutionalization of voluntarism. Indeed, state protection is sought to curb private corruption while state apathy, corruption, and interference has discouraged voluntary acts. Recent philanthropic action by members of the community seems to have preferred non-*waqf* forms, perhaps because of excessive government control over *waqf* under existing laws in place.

Waqf was always meant to be in the voluntary sector and not in the government sector. Efficient laws must be formulated and implemented to ensure a reversion to the original status of Islamic endowments as a mechanism that encourages voluntarism, benevolence, and philanthropy.

¹³ See "Azim Premji donates USD 2.3 billion after signing giving pledge," Forbes, February 23, 2013, <http://www.forbes.com/sites/naazneenkarmali/2013/02/23/azim-premji-donates-2-3-billion-after-signing-giving-pledge/>

¹⁴ See Obaidullah, M. (2013) *Awqaf Development and Management*, Islamic Research and Training Institute, Jeddah, Saudi Arabia, ch. 2.

Article

**THE NEW YORK NONPROFIT REVITALIZATION ACT,
FROM THE FOUNDATION OF THE SARBANES-OXLEY ACT
TO IMPLEMENTATION**

ISIDA TUSHE*

Introduction

Nonprofit organizations play a critical role by acting as a vessel to provide funding for projects that benefit society.¹ Services and grants in a wide variety of areas are important to institutions in the community, including healthcare, education, museums, and social-need organizations. The nonprofit sector has grown in size and diversity and has increased in prominence. More than 1.5 million nonprofit organizations are registered in the United States.² More than 92,906 of these nonprofits are active in New York,³ of which 74,269 are listed as 501(c) (3) nonprofit organizations. This non-exhaustive list includes public charities, private foundations, and other types of nonprofit organizations, including chambers of commerce, fraternal organizations, and civic leagues.

In the wake of news of scandals in nonprofit organizations, several states began to tout legislative solutions to the perceived notion of a nonprofit accountability gap. These legislative approaches followed the passing of the Sarbanes-Oxley Act of 2002 ("SOX"). The steps taken by the boards of for-profit organizations, including those required by Sarbanes-Oxley and related rules and regulations, have led to increased engagement on the part of board of directors.⁴

Stricter modifications of federal and state law regarding for-profit corporations have also been implemented. The new regulations for nonprofit corporations are not far disconnected from SOX regulations that were the foundation for their creation. More interesting, however, is the substantive link between these two sets of reforms, particularly the shared emphasis on the board of directors and fiduciary duties. Officers and directors are considered fiduciaries of the

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¹ Mark Sidel, *The Nonprofit Sector and the New State Activism*, 100 Mich. L. Rev. 1312, 1313 (2002) (book review) [hereinafter Sidel, *New State Activism*] (stating that the charitable sector is "'integral to the national economy and a valued part of [our] social fabric . . . [It] embodies the philanthropic goodness, conviviality, cultural excitement, and democratic spirit of the American people . . . [and] has provided a valued social location in which groups can operate without pecuniary obsessions and with measures of success that are not necessarily related to financial profitability.'" (quoting NORMAN I. SILBER, A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE NONPROFIT SECTOR 2 (2001))).

² National Center for Charitable Statistics (NCCS).

³ *Id.*, refer to state profile and pull up New York.

⁴ Deloitte, *The Guide to Not-For-Profit Governance* 2012.

nonprofit organization that they manage.⁵ The fiduciary duties of the board of directors are articulated in the Nonprofit Corporation Law (“NPCL”) of New York.

This article argues that IRS regulatory influence through the Sarbanes-Oxley Act has influenced the strong, ethical, and transparent nonprofit board governance as implemented in the New York Nonprofit Revitalization Act (“Revitalization Act”). Part I examines how the New York government first mimicked SOX by using it as a foundation for the NPCL to regulate nonprofits. This section further compares the Revitalization Act and the SOX. Part II charts the evolution of the NPCL until it emerged, renamed the New York Nonprofit Revitalization Act. Part III gives recommendations to build on the existing reforms in the nonprofit sector.

I. Regulations of Nonprofits

A. Federal Regulations: IRS

Nonprofit law combines corporate law, tax law, and trust law.⁶ The law regulating nonprofit organizations is relatively new compared to the law regulating for-profit corporations.⁷ Ordinarily, a nonprofit is incorporated under a nonprofit corporation statute. Incorporation is not required to operate as a nonprofit; however, incorporating is wise when seeking favorable tax treatment under the Internal Revenue Code.⁸ The IRS prohibits acts of self-inurement and self-dealing for tax-exempt organizations. IRC §501(c)(3) requires that the organization be operated exclusively for tax-exempt purposes and that “no part of [its] net earnings . . . inures to the benefit of any private shareholder or individual. . . .”

The role of the board of directors for nonprofits began to be addressed in IRS filings starting in 2008,⁹ which placed an increased focus on the scope of the obligations of nonprofit directors.¹⁰ In 2007, the IRS released Form 990 that requires disclosures on corporate governance and board of directors, making the nonprofit’s governance a matter of public record.

A nonprofit in Form 990 must indicate whether the governing board reviewed the form before it was filed with the IRS¹¹ and must verify that the form was actually presented to the

⁵ *Scheuer Family Foundation, Inc. v. 61 Associates*, 179 A.D. 2d 65, N.Y.S.2d 662 (1st Dept. 1992); *The Martha Graham School and Dance Foundation, Inc. v. Martha Graham Center of Contemporary Dance*, 224 F. Supp. 2d 567 (S.D.N.Y. 2002), *aff’d in part, rev’d in part on other grounds*, 380 F. 3d 624 (2d Cir. 2004).

⁶ Susan N. Gary, *Regulating the Management of Charities: Trust Law Corporate Law, and Tax law*, 21 U. Haw. L. Rev. 593 (1999) (discussing how trust law, corporate law, and tax law impact charities).

⁷ Kara A. Gilmore, *House Bill 1095: The New Nonprofit Corporation Law for Missouri*, 63 UMKC L. Rev. 633, 633 (1995) (“Nationally, nonprofit corporations have not received as much attention from lawmakers as for-profit corporations because the former do not impact the economic status of Americans as directly as for-profit corporations.”).

⁸ David S. Walker, *A Consideration of an LLC for a 501(c)(3) Nonprofit Organization*, 38 Wm. Mitchell L. Rev. 627 (2012) (“While the charitable trust form is an option and, for some, the unincorporated nonprofit association may be a viable choice, the ‘predominant’ form of charitable organization in the United States is the nonprofit corporation.”).

⁹ Karen Donnelly, *Good Governance: Has the IRS Usurped the Business Judgment of Tax-Exempt Organizations in the Name of Transparency and Accountability?*, 79 UMKC L. Rev. 163, 165-68, 181-91 (2010).

¹⁰ Grace Allison, *The New Form 990 for Tax Exempt Organizations: Revolution in Progress*, 37 Est. Plan. 14, 14-20 (2010) (discussing the enhanced Form 990 requirements and their effects on directors at nonprofits).

¹¹ I.R.C. Form 990, at 6, Question 11 (2011).

board prior to the IRS filing.¹² It further requires inclusion of a full description of the process for review by any of the organization's officers, directors, trustees, or management and disclosure of whether it was reviewed before or after it was filed with the IRS, which includes disclosure of who conducted the review, when it was conducted, and the extent of the review.

Other questions in Form 990 ask the nonprofit to address governance practices in setting executive compensation and disclosure of the number of independent voting members in the governing body.¹³ Also, the nonprofit must indicate whether its officers, directors or trustees, and key employees are required to annually disclose any personal interests that could give rise to conflicts.¹⁴ Additionally, Form 990 must disclose whether the process for determining CEO and other key officer and employee compensation includes a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision for the organization.¹⁵

Section 4958 applies to all organizations exempt under IRC sections 501(c)(3) (other than private foundations) and 501(c)(4). IRC §4958 proscribes "excess benefit transactions"¹⁶ between certain charitable organizations and "disqualified persons" (generally, those in a position to exercise "substantial influence" over the organization). Such regulations give the IRS the authority to impose penalty taxes (known as "intermediate sanctions" in contrast to the ultimate sanction, revocation of exempt status) when a transaction is found to bestow an excess benefit on a disqualified person. This legal doctrine was taken into consideration by the New York legislature for definitional purposes when drafting the Revitalization Act.

B. The Influence of Sarbanes-Oxley

SOX raised corporate governance standards of for-profit corporations. Regulators seized this opportunity to create similar reforms in nonprofit governance, in order to avoid further scandals.¹⁷ At the federal level such reforms quickly became moot; in fact the need for government reforms in nonprofits originated with tax laws rather than traditional corporate governance sources.¹⁸

SOX was passed in 2002 in the wake of corporate accounting scandals. Two criminal provisions apply to nonprofit organizations: provisions prohibiting retaliation against whistleblowers and provisions prohibiting the destruction, alteration, or concealment of certain

¹² *Id.*

¹³ Dana Brakman Reiser, *Director Independence in the Independent Sector*, 76 Fordham L. Rev. 795, 814-31 (2007).

¹⁴ I.R.C. Form 990.

¹⁵ *Id.*

¹⁶ An excess benefit transaction is one in which the economic benefit provides to the disqualified person is greater than the return itself to the applicable tax-exempt organization. IRC §4958(c)(1)(A).

¹⁷ Wendy K. Szymanski, *The Allegory of Good (and Bad) Governance: Applying the Sarbanes Oxley Act to Nonprofit Organizations*, 2003 Utah L. Rev. 1303, 1320-36 (2003).

¹⁸ Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 Del. J. Corp. L. 57, 60 (2009).

documents or the impediment of investigations.¹⁹ These two criminal provisions will not be discussed in this article. Instead this article focuses on the provisions of the board of directors, audit committee requirements, and auditor provisions of the SOX and how the revised amendments of the NPCL have made their way into the Revitalization Act, with definitional language changes and structural shifts.

Board of Directors Requirements

With the implementation of SOX, the focus shifted toward a perspective that management is working for the board of directors. Previously, it was common practice for the board of directors to act in service of the management. SOX further recognizes that director independence is necessary for the board to serve effectively as a check on management. SOX allows director liability if the board fails to exercise the appropriate oversight. This increased demand and need for independence has led to greater diversity among the people who serve on the boards. Furthermore, SOX mandates the creation of an audit committee.

Audit Committee Requirements

SOX requires that the audit committee of a company's board of directors appoint, compensate, and oversee the auditor's work.²⁰ Additionally, it mandates that each corporation create and maintain an independent and competent audit committee.²¹ This committee remains apprised of all "critical accounting policies and practices" used by the company's outside auditors.²² It requires that each member of the audit committee be an independent board member, which the act defines as "a person who holds a voting seat on the board but has no other stake in the corporation."²³ Further, the audit committee members may not be affiliated with the company or its subsidiaries, and they may not receive fees from the company beyond their compensation for serving on the board of directors and the audit committee.²⁴ The law also encourages companies to have financial experts on the audit committee by requiring companies to disclose whether their committees include at least one financial expert and, if not, the reasons why.²⁵

Auditor Provisions

SOX prohibits auditors from providing certain non-auditing services along with an audit; it requires the audit committee to pre-authorize the audit and permissible non-audit services (such as tax services, bookkeeping, actuarial services, management or human resources services, and legal services); and it requires that all audit committee approvals of non-audit services be disclosed.²⁶ It requires that the lead partner of a company's outside auditing firm be rotated off

¹⁹ See American Bar Association, Standing Committee on Pro Bono & Public Service and the Center for Pro Bono. Nonprofits and Sarbanes-Oxley, http://americanbar.org/legalservices/probono/nonprofits_sarbanes-oxley.html.

²⁰ Sarbanes-Oxley Act §301.

²¹ Stephen J. McNally & Joseph T. Steuer, *Case Study: Can Sarbanes Oxley Hold the Keys to Nonprofit Governance?*, WEBCPA, Feb. 2013, 2006, <http://www.webcpa.com/article.cfm?articleid=18822&print=yes>.

²² Sarbanes-Oxley Act § 204.

²³ *Id.* § 301(3).

²⁴ *Id.* §301.

²⁵ *Id.* §407(A).

²⁶ *Id.* §202.

the company's audit committee every five years²⁷ and prohibits an auditor from providing audit service to a company if the auditor employed the company's CEO, CFO, Chief Accounting Officer, or controller and such individual participated in any way in the audit of the company within one year before the initiation of the audit.²⁸ This provision is meant to minimize risk of collusion between the company and the auditor.²⁹ Third, SOX mandates that a top corporate officer certify the accuracy of the company's financial statements and holds this officer personally liable for fraudulent claims in these disclosures.³⁰ These provisions have given the audit committee greater powers and more responsibilities. Essentially, if the audit committee of the board does not address reports of misconduct from independent auditors, the independent auditors have the obligation to inform the SEC. This creates a check-and-balances system. It mandates increased communication between the audit committee and the auditor, placing responsibility for all aspects of the audit with the audit committee while enabling the auditor to act without any conflict of interest.³¹

SOX does not address "related party transactions" under the same microscopic view as the Revitalization Act does. In fact no such section exists. However, SOX does require both the board and the audit committees to review their existing codes of conduct or conflict of interest policies with particular focus on practices concerning related-party transactions. When dealing with related transactions, the audit committee may take an expansive view of what is considered a "related party" and focus on non-arm's length transactions in addition to relationships required to be disclosed by the SEC.

II. Not-for-Profit-Corporation Law in New York

New York Attorney General Andrew Cuomo continued the initiative to enact a nonprofit law that the previous attorney general, Eliot Spitzer, had begun. In 2010, two new governance rules amended New York's version of the Uniform Prudent Management of Institutional Funds Act, requiring (a) that organizations have a written investment policy and (b) that boards document the prudence analysis accompanying decisions to draw funds – even to appropriate the annual draw – from endowment.³² On September 17, 2010, New York governor David Paterson signed into law the New York Prudent Management of Institutional Funds Act ("NYPMIFA").³³ A year later, Attorney General Eric Schneiderman convened the Leadership Committee for Nonprofit Revitalization, which ultimately developed the New York NPCL and then later amended it to what is now the New York Nonprofit Revitalization Act ("Revitalization Act").

²⁷ *Id.* § 203. ("It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner . . . has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.")

²⁸ *Id.* §206.

²⁹ BoardSource & Indep. Sector, *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations* 5 (2003), available at <http://www.boardsource.org/clientfiles/SarbanesOxley.pdf>.

³⁰ Sarbanes-Oxley Act § 906(c).

³¹ Daniel L. Kurtz, *Nonprofit Governance* (2003).

³² New York Revitalizes: State Governance Reform for Nonprofits.

³³ New York Prudent Management of Institutional Funds Act, Ch. 490 § 1, 2010 N.Y. Laws 1334.

The Revitalization Act, passed in December 2013, took effect on July 1, 2014. It amended the NPCL and related laws affecting nonprofit organizations. The Act makes several changes to the laws governing New York nonprofits in an attempt to shore up board independence, improve accountability, and modernize outdated provisions. These new provisions apply to nonprofits that are incorporated in New York, but one significant section – related to financial audits and financial reporting to the state—applies to all nonprofits that are required to register in New York for charitable solicitation purposes. The focus of this article is those provisions dealing with independent governance, audit, and oversight. Under the NPCL, a nonprofit may have standing and special committees of the board in addition to committees of the corporation.³⁴ The Revitalization Act eliminates the concept of standing and special committees and clarifies that committees include committees of the board and committees of the corporation.

Audit Committee and Audits

Following the lead of the SOX and the IRS rules, the Revitalization Act places a great deal of focus on ensuring the independence and objectivity of the board and its directors. For example, an employee can no longer serve as the chair of the board or hold a position with similar responsibilities. This provision makes it illegal for one person to lead the administration of an organization and its governance. The responsibility must be divided between multiple parties who work in tandem. This minimizes collusion by separating powers. One party can provide information regarding the many facets of the nonprofit to help the board understand the situation but is unable to affect the discussion or the vote of the board's decision.

The Revitalization Act requires a nonprofit organization to have at least two types of committees: (a) committees of the board, which are made up solely of board directors, and (b) committees of the organization, which can contain a mix of directors and non-directors. Only committees of the board can bind the organization. Additionally, the Revitalization Act requires that the directors be independent and not have significant financial involvement in the organization.

The Revitalization Act also increases the threshold amounts for requiring a CPA audit. Under the Act, a nonprofit corporation with annual revenue in excess of \$500,000 must establish an audit committee composed solely of independent directors,³⁵ or, alternatively, have the independent directors of the board serve the functions of an audit committee. The audit committee or independent directors are required to oversee the accounting and financial reporting processes of the entity as well as the annual audit of the entity's financial statements,

³⁴ Non-Profit Revitalization Act, 2013 §712.

³⁵ "Independent director" is defined in Section 102(a)(21) as a Director who: (1) is not, and has not been within the last three years, an employee of the corporation or an affiliate of the corporation, and does not have a relative who is, or has been within the last three years, a key employee of the corporation or an affiliate of the corporation; (ii) has not received, and does not have a relative who has received, in any of the last three fiscal years, more than \$10,000 in direct compensation from the corporation or an affiliate of the corporation (other than reimbursement for expenses reasonably incurred as a director or reasonable compensation for service as a director as permitted by paragraph (A) of Section 202(general and special powers)); and (iii) is not a current employee of or has a substantial financial interest in, any entity that has made payments to, or received payments from, the corporation or an affiliate of the corporation for property or services in an amount which, in any of the last three fiscal years, exceeds the lesser of \$25,000 or 2% of such entity's consolidated gross revenues. For purposes of this subparagraph, "payment" does not include charitable contributions.

including by retaining an independent auditor to conduct the audit and reviewing the audit results with the auditor. These additional review requirements of the audit committee apply to corporations with annual revenue greater than \$1,000,000 in the prior fiscal year. It is worth noting that there is no requirement that all directors be considered “independent” – rather, the focus should be on ensuring that certain governance functions, such as audit oversight, are within the exclusive control of independent directors.³⁶

Additionally, the Revitalization Act relaxes certain audit-related thresholds related to financial reporting with the Attorney General for nonprofits. Corporations receiving gross revenue and support greater than \$500,000 in a fiscal year will be required to file an annual fiscal report and an audit report prepared by an independent CPA with the Attorney General.³⁷ Corporations receiving gross revenue and support greater than \$250,000 but less than \$500,000 in a fiscal year will be required to file with the Attorney General an annual financial report and a review report prepared by an independent CPA. Corporations receiving gross revenue and support less than \$250,000 in a fiscal year will be required only to file an audited financial report with the Attorney General.³⁸

These new requirements raise the threshold requirements for the filings. They benefit the organization with revenue of \$100,000 to \$250,000, because it is relieved of a review or audit done by an outside CPA. The filing requirement was burdensome to smaller nonprofits, and the increased thresholds make it easier for smaller nonprofits to comply. However, audits are a key step in avoiding mishaps. It was through an audit that the missing funds were uncovered in the case of the former financial director for a New York Chapter of the American Red Cross.³⁹ In the case of H.O.W. Foundation,⁴⁰ the former executive director wrote himself 213 unauthorized checks for a total of more than \$1.35 million and embezzled more than \$200,000 from a thrift store operated by the nonprofit over eight years.

The Revitalization Act defines an “independent director” as one who is not, and who has not been within the last three years, an employee of the corporation or an affiliate of the corporation, and who does not have a relative who is, or who has been within the last three years, a key employee of the corporation or an affiliate of the corporation.⁴¹ However, the nonprofit is given leeway by allowing the independent director to receive no more than \$10,000 as direct compensation, or a financial interest in an entity that adds up to no more than \$25,000 or 2 percent of the corporation’s gross revenue for property or services (whichever is less).⁴² The

³⁶ *Id.*

³⁷ This threshold will increase to \$750,000 in 2017 and \$1,000,000 in 2021.

³⁸ Revitalization Act Section 102.

³⁹ In 2013, the former financial director for New York Red Cross Chapter was sentenced to two to seven years in prison for grand larceny. As signatory of the chapter’s operating account, she obtained an ATM debit card in her name that was linked to the chapter’s account to make cash withdrawals, as often as every few days in some instances. She used the money to pay for clothing, her children’s tuition, and other personal expenses, embezzling over \$274,000 between 2005 and 2009.

⁴⁰ A nonprofit alcohol and drug treatment center in Tulsa, Oklahoma.

⁴¹ New York Nonprofit Revitalization Act Section 102(a)(21)(11).

⁴² New York Legislature Passes Nonprofit Revitalization Act: Comprehensive, Significant Changes to New York Nonprofit Corporation Law on Horizon, *Journal of Multistate Taxation and Incentives*, March/April 2014.

definition is controversial in that not only is it unique among states but it is also found nowhere else in New York nonprofit law or in IRS rules. It is similar to a question on Form 990⁴³ but the definition differs. The term affiliate means entity controlled by, in control of, or under common control with corporation. The term “control” remains undefined under the IRS Form 990 and the Revitalization Act. This is a high bar because it makes it difficult to find independent directors.

Also, “substantial financial interest” remains undefined in the Revitalization Act. The question arises as to whether this means a senior manager or someone with an ownership interest. Say, for example, that a member of the board of directors of a theater company buys a ticket to one of the group’s performances with his own money. Does he need to disclose the material facts about the ticket purchase, even though he paid the same price as the general public? In the case of a hospital board and a director whose relative is a private pay patient or has high-deductible insurance plan, does the hospital board need to pre-approve emergency medical treatment? If the related party has “substantial financial interest,” then “alternative transactions to extent available” must also be considered, but this is not defined, so it raises questions such as whether it is a de facto bidding requirement. Are a certain number of bids required? Must they be in writing? Is publicizing required? These questions remain unanswered.

Furthermore, Section 102(a)(21)(ii) of the independent director definition makes note of relatives. This is identical to the IRS definition under the Excess Benefit Doctrine.⁴⁴

Related Party Transactions

The Revitalization Act revised NPCL § 715 and increased the approval and oversight powers of the board of directors for transactions involving “related parties.”⁴⁵ It replaced a provision governing transactions of “interested directors and officers” with a new provision regarding “Related Party Transactions,” which are defined as transactions between the organization or any of its affiliates and a related party who has a financial interest in the transaction.⁴⁶ This term is now more specific. Directors and trustees may not enter into the transaction unless the transaction meets the standard “fair, reasonable and in the corporation’s best interest at the time of such determination.”⁴⁷ Further, any director, officer, or “key employee” who has an interest in a related party transaction must disclose in good faith to the board, or an authorized committee, the material facts concerning the interest.

In the evaluation process, the Board of Directors must (i) consider alternative transactions to the extent possible; (ii) approve the transaction by a majority vote of directors present at the

⁴³ Form 990 possess four questions to determine the “independent” factor: (a) Were you compensated as an officer or other employee from this or a related organization?; (b) Did you receive total compensation or other payments exceeding \$10,000 for the year from this or a related organization as an independent contractor?; (c) Did you receive, directly or indirectly, material financial benefits from this or a related organization?; (d) did you have a family member that received compensation or other material financial benefits from this or a related organization?

⁴⁴ This was in response to an amendment to IRS in the 1990s that enacted new standards for evaluating compensation, mainly in nonprofits listed as 501(c)(3) and 501(c)(4)s.

⁴⁵ “Related party” is defined in Section 102(a)(23) as (i) any director, officer, or key employee of the corporation; (ii) any relative of a director, officer, or key employee of the corporation; or (iii) any business entity in which a person described in clauses (i) or (ii) has a 35% or greater ownership stake.

⁴⁶ *Id.*

⁴⁷ NPCL Section 715(a).

meeting; and (iii) document the approval by the Board of Directors, including any discussion regarding alternative proposals. As to what extent related party transactions are intended to overlap with conflicts of interest, it remains unclear, but it appears that all related party transactions are likely potential conflicts of interest and that there may be additional conflicts of interest that are not related party transactions. This requires nonprofit boards to subject such transactions to careful scrutiny.

In the NPCL, the “financial interest” is applied to any transaction between two corporations which may have a director or officer in common but in which the director does not have a financial interest. This provision was dropped in the Revitalization Act, resulting in a possible conflict of interest. For example, a conflict that wouldn’t be covered would be two nonprofits collaborating with each other and sharing a director. This is no longer a conflict of interest on the face of the statute.

At first glance, the “key” employee section might appear to derive directly from the IRS statute. However, the IRS statute uses the term “person with substantial interest” and not “key employee.” The IRS regulation encompasses more than employees. The “ownership or beneficial interest” under Section 102(a)(23)(iii)(ii) is consistent with IRS regulations. This is addressing persons who have a significant interest in vendors with which nonprofits may be doing business.

Contrary to the SOX, the Revitalization Act does not provide a check and balances system by requiring both the board and the audit committee to review any related party transactions; rather, it gives that task to the board of directors or authorized committee. This requires scrupulous review of transactions. One result of the absence of checks and balances is the Project Genesis case.⁴⁸ On October 12, 2013, the former CFO of Project Genesis, a Connecticut nonprofit organization that served people with disabilities, was sentenced to 33 months’ imprisonment after embezzling more than \$348,000 from the organization over a three-year period. He stole such funds by keeping terminated employees on the payroll and then transferring their salaries to his personal bank account.⁴⁹

If the board of directors does not follow the prescribed procedures, the Revitalization Act authorizes the attorney general to bring action to enjoin, void, or rescind the related party transaction and to seek restitution, to remove directors and officers, or to take other remedial actions.⁵⁰ With respect to these provisions, there is no “de minimis” threshold, and in the case of willful or intentional misconduct, the attorney general is authorized to require a corporation to repay double the amount of improperly obtained benefit.⁵¹ This gives the attorney general plenty to shoot at in challenging transactions. The power to “void” a transaction may have profound consequences. It may determine how the power will be administered and how much deference a judge gives to the board of directors’ statements.

⁴⁸ FBI Press Release 2012, former CEO of Willimantic Non-Profit Admits Embezzling More than \$348,000.

⁴⁹ *Id.*

⁵⁰ Keith J. Kehrer and Chaeri K. Tornay, New York’s Nonprofit Revitalization Act of 2013 and Its Impact on Nonprofit Organizations, April 2, 2014.

⁵¹ *Id.*

Violation may go beyond improper benefit to include failure to approve a transaction. This contracts the IRS excess benefit rules, under which an organization can demonstrate a transaction is reasonable even if not approved in advance. The IRS rules are structured to encourage the organization to do everything upfront. If so, the IRS gives deference to that process or decision. Under the Revitalization Act, the attorney general would have the power to say that the reasonableness of the transaction does not matter, a departure from federal law.

Furthermore, prior to initial election and at least annually thereafter, each nonprofit corporation must require directors to sign and submit a written statement identifying those entities in which they have relationships as officers, directors, owners, or employees, and with which the nonprofit corporation has a relationship. This statement must also include any transaction in which the nonprofit corporation is a participant if the director may have a conflict of interest. These statements must be provided to the chair of the audit committee for review upon completion. The approval process is in parallel to the IRS “excess benefit” rules except for independent director requirement. Procedures to deal with the IRS regulations will satisfy Revitalization Act regulations.

III. Recommendations and Conclusions

Organizations in small communities might struggle with finding a sufficient number of “independent” directors to serve on the audit committee given the Act’s stringent definition. However, the limitation is balanced in the Revitalization Act’s requirement of less scrutiny of reporting by smaller nonprofits. Regulatory intent seems to be to increase the impartiality and independence of board members, resulting in less chance of collusion within the organization.

Requiring the use of an independent audit committee by the nonprofit will provide an effective way to maintain control and objectivity, thus ensuring a foundationally secure financial process that is able to detect and prevent financial mismanagement. Not specifying a number of individuals that must be on the board will give leeway for small nonprofits to leverage the board position by appointing qualified and knowledgeable individuals to oversee the financial aspect of the organization. Management and board members are often more trusting, which leads to less stringent financial controls for nonprofits.⁵² However, a belief that audits will catch any fraud is flawed. The Association of Certified Fraud Examiners reports that less than 10 percent of frauds are discovered as a result of an audit by an independent account firm.⁵³ Auditors only have a responsibility to give “reasonable” assurance that no material misstatements in financial statements have been made.⁵⁴ This is a low standard. Therefore, external audits are crucial in ensuring that effective financial controls and fraud prevention measures are being followed.

The nonprofit sector is self-regulatory. The best way to take full advantage of the Revitalization Act would be to bifurcate the nonprofit board into a board of directors-managers responsible for day-to-day management of activities and a supervisory board of advisors charged with oversight of such management board. The board of directors would owe fiduciary duties to its members and to beneficiaries but not concern itself with managing the nonprofit organization.

⁵² William H. Devaney and Jeffrey S. Tenebaum, Preventing Embezzlement and Fraud in Nonprofit Organizations, May 4, 2011.

⁵³ *Id.*

⁵⁴ *Id.*

This board could serve as the audit committee and report annually to the appropriate authorities. These advisors cannot be employees of the nonprofit, therefore obeying the Revitalization Act.

The Revitalization Act's focus is on the independence of directors. Adopting audits and audit committees is a development out of the SOX that does not take into consideration the complexity and diversity of the charitable sector, merely the financial revenue of the organization. The SOX provided a heightened scrutiny environment for audit committees and outside auditors in the for-profit sector. It made the audit committee directly responsible. This important characteristic is now in the Revitalization Act, and the audit committee is virtually the one responsible if accounting and financial processes go wrong.

The nonprofit standards set in the Revitalization Act are tailored toward the business corporate standard as set forth in the SOX. This shift in the governance of internal matters within a nonprofit should be salutary. To be sure, applying blanket standard to the actions and responsibilities of all board members for all nonprofits may be too lenient, because it ignores the special public purpose carried by nonprofits, the nature of the nonprofit board, and the inadequacy of internal control and enforcement. This highlights the differences between the Revitalization Act and SOX. The Revitalization Act considers the size and financial revenue of the organization, which makes it easier for smaller nonprofits to comply with regulations. However, the Revitalization Act mandates that the nonprofit organizations fill the positions of board members and audit committees with individuals academically prepared for these roles rather than just the individuals with the deepest pockets, inasmuch as those who might be interested in board membership are often dissuaded out of concerns of liability.

It would be wise to add a clause protecting directors from monetary liability for unintentional fiduciary duty breaches, as with Delaware businesses and nonprofits. Such a provision may have been omitted because of the widespread scandals, but it should be reassessed.

Modeling the requirements pertaining to board of directors, audit committees, and auditors of the New York Nonprofit Revitalization Act on the Sarbanes-Oxley Act is a proactive step to reduce the risk of future scandals in the nonprofit sector. The checks-and-balances system is a step forward to ensure that fraud and corruption do not diminish public trust in nonprofit organizations. But as we see evidence of how the Revitalization Act affects the nonprofit industry, the law must continue to evolve.

Chart 1: Changes in the NPCL amendments to New York Nonprofit Revitalization Act

	NPCL Amendments	New York Non-Profit Revitalization Act (Current Law)
Governance	Requires the board of directors, board of trustees, or other governing body of a nonprofit corporation to consist of at least three individuals. There continues to be no cap on the number of directors who may serve.	Prohibits an employee of a nonprofit corporation from serving as the chair of its governing board or holding any other title with similar responsibilities.

	NPCL Amendments	New York Non-Profit Revitalization Act (Current Law)
Types of Committees	Nonprofit may have standing and special committees of the board in addition to committees of the corporation.	Nonprofit corporations may establish and maintain two types of committees: (1) a “committee of the board,” whose members must be members of the board, which may be delegated powers of the board and which can exercise authority to bind the corporation; (2) a “committee of the corporation,” which may include directors and non-directors. Also dispenses with the distinction between standing and special committees.
Related-Party Transactions	<ul style="list-style-type: none"> • Gave rise to questions as to whether any director or officer involved was fulfilling duty of loyalty to the organization; such transactions, if approved and entered into, were valid, binding, and enforceable against the organization. • Financial interest applied to any transaction between two corporations that may have a director or officer in common. 	<ul style="list-style-type: none"> • The presumption is that a related-party transaction is invalid and therefore unenforceable unless the organization’s governing body determines that the transaction is fair, reasonable, and in the best interest of the organization. A “related party” is a person who serves as a director, officer, or key employee of the nonprofit organization or any affiliate thereof, or is any such person’s relative. “Related party” also includes any entity in which any of the foregoing individuals has a 35% or greater ownership or beneficial interest, or, in the case of a partnership or professional corporation, a direct or indirect ownership interest in excess of 5%. • This provision regarding financial interests was dropped completely.
Audit-related thresholds (gross revenue)	<p>Requirements before July 1, 2014</p> <p>< \$100,000: no accountant’s report required</p> <p>\$100,000-\$250,000: independent accountant’s review report and financial statements with accompanying notes</p> <p>> \$250,000: independent accountant’s audit report and financial statements and accompanying notes.</p>	<p>Requirements through June 30, 2017</p> <p>< \$250,000: unaudited financial report</p> <p>\$250,000-\$500,000: Independent CPA review report</p> <p>> \$500,000: Independent CPA audit report</p> <p>Requirements beginning July 1, 2017</p> <p>< \$250,000: Unaudited financial report</p> <p>\$250,000-750,000: Independent CPA review report</p> <p>> \$750,000: Independent CPA review report</p> <p>Requirements beginning July 1, 2021</p> <p>< \$250,000: Unaudited financial report</p> <p>\$250,000-\$1,000,000: Independent CPA review report</p> <p>> 1,000,000: Independent CPA review report</p>

	NPCL Amendments	New York Non-Profit Revitalization Act (Current Law)
Financial Statements	Responsibility was divided between multiple board members and/or parties who had to work in tandem to achieve success	The board, or a board-designated audit committee composed only of independent directors, must oversee the accounting and financial reporting processes of the nonprofit and the auditing of financial statements. Oversight includes retaining auditors and reviewing audits, if required, on an annual basis. Attorney General can require an organization to have its financial statements audited, even if the organization's gross revenue is below the threshold limit. See audit-related thresholds below.

Article

WHAT NONPROFIT BOARD MEMBERS AND MANAGERS DON'T KNOW CAN HURT THEM FINANCIALLY: IRS FORM 990 AND THE INTERMEDIATE SANCTIONS ACT

EUGENE H. FRAM, ED.D¹

Nonprofit 501(C)(3) charitable organizations and 501(C)(4) social welfare organizations fall under two IRS regulations—the extended annual Form 990 and the Intermediate Sanctions Act (Act). Form 990 requires answers to 38 corporate questions on corporate governance operations. The Act covers prohibitions related to providing or seeking excess benefits. Most board members know about the Form 990, but few know about its board obligations; and few board members and managers know the Act exists. With the IRS aggressively enforcing the Act to eliminate faux nonprofits, unwitting nonprofit board directors and managers can become ensnared financially.

Two classes of nonprofit organizations, 501(C)(3) charitable organizations and 501(C)(4) social welfare organizations, are covered by two IRS regulations not applicable to for-profit corporations.

One regulation requires the organization to file an IRS Form 990 each year, including financial data plus answers to 38 questions related to corporate governance. Many board members may be unaware of their obligations to be involved in preparation of the form each year. If there were an audit involving the 38 board questions, further, board members might be expected to know about any exceptions to be reported, such as conflicts of interest. For example, any board member whose firm or employing firm has a business relationship with the nonprofit must specify it as a conflict of interest on Form 990 and probably abstain from voting on related issues. Also, if the report is late, the nonprofit must file an IRS form, and the board needs to be advised of the situation.

If the organization ignores any of the requirements, it can lose its tax-exempt status—a penalty already imposed on thousands of smaller nonprofits. In some instances, moreover, failure to heed the requirements might leave nonprofit board members open to personal liability for failing in their corporate duties for “due care.”

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The suggestions presented in this article are based on field observations as a veteran for-profit and nonprofit director and consultant. They should not be construed as offering legal advice.

Parts of this article contain revised and updated material from Eugene Fram & Elaine Spaul (2001) “Expectations for Nonprofit Boards are Changing,” *Nonprofit World*, May/June, and reflect the expertise of Elaine Spaul, Ph.D., J.D.

Another obligation to which nonprofits must adhere is the Intermediate Sanctions Act, Internal Revenue Code section 4958 (the Act). The Act was passed by Congress in 1996 with temporary rules of enforcement, but it was not robustly enforced until about 2002. Although they can be financially ensnared by the 20-year-old Act, very few nonprofit board members and managers seem to know it exists. In making conference presentations to nonprofit directors, CEOs, and managers, in fact, I find that ignorance of the law is frightening.

From press coverage and elsewhere, board members and managers are generally aware that their organizations can be in trouble if they pay unreasonable compensations. But they are unaware of other sections of the Act that can lead to personal liability for board members, senior managers, and even such tangential persons such as volunteers and vendors.

History of the Intermediate Sanctions Act.

Up to 1996, the IRS had only one tool to sanction nonprofit organizations that violated its regulations: It could revoke the organization's tax-exempt status, a difficult and costly legal process. Without fraud or a lack of "due care," the IRS was powerless to hold individual board members or managers financially responsible.² The need for the Act was prompted by several scandals in which CEOs and/or board members of high-profile organizations used their positions to unjustly enrich themselves.

To give the IRS a tool to target those responsible for such activity while allowing the nonprofits to retain their tax-exempt status and continue serving clients, Congress passed the Intermediate Sanctions Act. "The legislative history of section 4958 provides that intermediate sanctions ... may be imposed ... in lieu of, or addition to, revocation of and organizations tax-exempt status—H. Rep. No. 104-506."³

Importance of Excess Benefits and Disqualified Persons

The key to the Act is what one part of the legislation calls an *excess benefit*. An excess benefit can develop in ways other than paying above-market wages. The IRS may consider as excess benefits the nonprofit's above-market payment for an asset or its disadvantageous financial arrangements with other organizations. A fundraising group that receives an excessively generous travel budget from a nonprofit group can also be in violation of the Act. Those giving and those seeking an excess benefit can both be liable.

The Act also specifies who may be liable under its provisions, identified with the curious title of *disqualified persons*:

Disqualified persons include organization officers, board members and their relatives. [More importantly] the disqualified persons category also can be extended to people not on the staff or board if they are in a position to exercise substantial influence over the organization's affairs. For example, if a volunteer agrees to chair a program task force, that person may be considered a disqualified person. Major donors also may fall into this

² Even when charged by state regulators, one board refused to back down on an excess salary. See: <https://nonprofitquarterly.org/2014/08/04/trustees-of-queens-library-dismissed-after-defending-high-ceo-salary/>

³ David A. Levitt (2009) "Excess Benefit Transactions Under Section 4958 and Revocation of Tax-Exempt Status," *Practical Tax Lawyer*, spring.

category, even if their only role is to provide resources. The legal reasoning is that such people have the ability to exercise substantial influence over the organization.⁴

In simple terms, those receiving the benefit as well as board members and managers approving it are all subject to the Act.⁵

In addition, if some benefits are not included in the recipient's W-2, they are considered an *automatic* excess benefit that must be reported on the public IRS Form 990. As of 2008, the IRS has the power to revoke the organization's tax-exempt status if it is found guilty of one or more excess benefits transactions.⁶

Personal Tax Sanctions

The IRS levies penalties in an unusual way. They are added to the income tax bill of the individuals found responsible:

For example, if a section 501(C)(3) organization were found to have paid \$150,000 to a disqualified person in a transaction for which \$100,000 was fair market value, the disqualified person would have to pay a tax of 25% of \$50,000 or \$12,500 to the IRS. In addition the disqualified person would have to return the excess benefit of \$50,000 to the organization, or be subject to the 200 percent penalty tax (\$100,000).⁷

Enforcement of IRS 4958

To assess the level of enforcement of the Act, I contacted four practicing attorneys, two of whom specialize in actions related to the Intermediate Sanctions Act. Three cited only one court case related to a merger situation in which section 4958 was a primary issue.⁸ All agreed that the IRS is settling cases without litigation.

Two attorneys suggested that the IRS might be following a procedure common to administrative agencies:

- The agency identifies an action as a violation of a statute, sometimes with modest evidence.
- The agency proposes a settlement. If the accused agrees, the case is resolved.
- If the case is not resolved, the agency takes aggressive actions to obtain a settlement—sometimes euphemistically called “rattling the cage.”
- If there is no settlement, the agency submits the action for trial or concedes the case.

With so few court cases on record, those accused seem to be acquiescing in the charges. One hopes that all of these are nonprofits that have been established for self-interest.

⁴ Eugene Fram & Elaine Spaul (2001) “Expectations for Nonprofit Boards are Changing,” *Nonprofit World*, May/June.

⁵ David A. Levitt (2012) “Automatic Excess Benefit Transactions,” *Nonprofit Law Matters*, Adler & Colvin, March 22.

⁶ Levitt (2009).

⁷ Levitt (2009).

⁸ Carracci v. Commissioner, <http://caselaw.findlaw.com/us-5th-circuit/1147472.html>

Such a process, however, can easily ensnare well-meaning nonprofit directors, managers, or even volunteers who unwittingly approve an excess benefit. In my opinion, nonprofit directors with nontraditional backgrounds may face a particular risk. In some states, nonprofits such as medical facilities are required to have current or former clients on their boards, which could leave some low-income people facing significant tax liabilities. These persons can be placed in a precarious situation, especially if their D&O policies do not cover losses levied under the Act.

A Hypothetical Case

Following is a statement from a D&O policy that *does* cover the Act:

Costs of Defense incurred by the Insured. Loss shall not include: (1) criminal or civil fines or penalties imposed by law, or taxes (except for the 10% “excess benefit” tax assessed by the Internal Revenue Service against any Insured Person pursuant to 26 USC Section 4958 (a))

Would naïve volunteer board members who approve an excess benefit be covered under such a D&O policy? It is highly possible that an inept CFO and/or external auditor might be at fault for the IRS bringing an action.

The naïveté about the Act extends beyond untutored volunteer board members. I have encountered certified public accountants and attorneys, including one representing a national legal association, who had no idea the law existed. I have also encountered a competent CFO who had unintentionally failed to add an excess vacation benefit to an employee’s income. Fortunately, the auditing firm found the error. If it had not done so, the IRS could have deemed the error an automatic excess benefit. Obtaining a claim rescission would have entailed substantial legal costs and dedicated management time.

In sum, ignorance of the Intermediate Sanctions Act can be financially devastating to well-meaning people. Nonprofit board education is needed in the area. In particular, all board members ought to

- Be alert: Every board member should know that the Act covers much more than paying higher salaries and identifying disqualified persons. Well-meaning outsiders, such as donors and revenue-sharing organizations, could be deemed part of an operating partnership that might be ensnared by Section 4958.
- Know about compensation and benefits: Nonprofits frequently delegate compensation decisions regarding the executive director or CEO to the board chair or a few senior board members. The entire board should review all salary schedules every year. If questioned by the IRS, every board member should know the compensation of the three or five highest-paid persons. All of this needs to be completed before a salary increase is awarded.
- Make certain records are kept: If the organization is audited, it will need records of any transaction being questioned. Board members who are unsure whether a transaction might involve an excess benefit should ask the board to seek competent legal counsel. The existence of an excess benefit may fall in a gray area. It could well be fact-based, in light of practices of comparable organizations. But counsel could flag whether the potential exists for the payment or benefit to be deemed an excess benefit. If the board refuses to accept the view of counsel, board members who might perceive it to be an

excess benefit should vote “no” on the transaction and make certain their votes are clearly recorded in the meeting minutes in order to avoid liability. When in danger of approving an excess benefit, it is not a good idea “to go along to get along,” a culture that seems to pervade nonprofit boards.

- Know about safe harbor provisions: The IRS says boards should take certain actions before making any decision that might be construed as involving an excess benefit—for example, using organization funds to support an executive director’s trip to Europe after 20 years of service. The board should first appoint a group of disinterested board members or a formal board committee of disinterested persons to approve such a transaction, and it should ensure that the group’s decision rests on comparable data gathered by disinterested field experts. For the European trip, it would be best to determine if such a reward were standard industry practice, in case the IRS questions the transaction.
- Make certain all directors’ and officers’ D&O liability insurance policies cover excess-benefit tax sanctions. If not, they should seek coverage. Some policies may exclude indemnity coverage where there is a violation of law.
- Make certain that the annual conflict of interest statement signed by board members, managers and other disqualified persons includes some reference to the Intermediate Sanctions Act.
- Have counsel review appropriate bylaws, operating guidelines, principles or policies, etc., to make certain that all compensation processes and other major transactions comply with the Intermediate Sanctions Act.