SUBMISSION TO TREASURY

DEVELOPMENT OF NFP GOVERNANCE STANDARDS

1. BACKGROUND

1.1 This submission responds to the December 2012 consultation paper issued by Treasury entitled "Development of governance standards", using terms and acronyms defined in the paper. Aspects of this submission should be taken to be a response to the COAG January 2013 paper "Regulatory Impact Assessment of Potential Duplication of Governances and Reporting Standards for Charities".

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1.3 The views expressed are based on the experience of the writer and his law firm in acting for charitable entities, including Australian companies, overseas companies carrying on activities in Australia, trusts and incorporated associations, which are tax exempt and deductible gift recipients. The assistance of Mr Ivor Kovacic, a lawyer with Piper Alderman, in preparing this submission, is acknowledged. The views expressed do not necessarily reflect the views of the firm.

2. EXECUTIVE SUMMARY

2.1 According to ATO data, if we leave aside unincorporated clubs and associations, and incorporated associations, the most common forms of charities with which the ACNC Act is concerned at this time are public companies limited by guarantee and trusts established by will or *inter vivos* trust instrument, both companies and trusts being equally relevant as vehicles for charities. Accordingly this submission addresses the implications of the proposed governance standards for charities in the form of companies and trusts.

2.2 The ACNC Act and proposed Regulations have important implications for the separation of powers doctrine. Prior to the present reform taking effect, the determination of charitable status (and tax consequences) was the subject matter of judicial interpretation of the tax legislation and common law concerning trusts for "charitable purposes". The apparent purpose and effect of the ACNC Act and proposed Regulations is to remove this determination from the province of the courts and legislature and make it the subject of administrative fiat by the executive arm of government. This is undesirable and treads a delicate line along the separation of powers.

2.3 The manner in which this change is to be effected is:

(a) the ACNC Act currently does not clearly specify the conditions of eligibility for registration. That is, s 25-5(3)(a) uses the concept of "not-for-profit entity" without defining it. That term will remain undefined until the Tax Laws Amendment (Special Conditions for Not-for-profit Concessions) Bill 2012 is passed, at which time the definition yet to be inserted in the tax legislation will be adopted for the purposes of the ACNC Act. The proposed definition is not in terms appropriate to trusts, and does not refer to charitable purposes but to entities which prohibit distributions to owners or members. The result may be that charitable trusts are no longer eligible for tax concessions, i.e. may be forced to incorporate. However, this is unclear. Section 25-5(5) provides that, to be eligible for registration, entities must be "Charitable". This is undefined but presumably has the meaning under the general law (as modified by the *Extension of Charitable Purpose Act* 2004 (Cth)).

(b) the proposed governance standards are a separate eligibility condition (see s 25-5(3)(b)). However, the proposed standards seek to re-state and qualify (and hence bring under the discretionary control of the ACNC) the basic entry level conditions referred to above, i.e. the purpose and "character" of a "not-for-profit entity" (see standard 1). The word "character" creates an unnecessary qualification: either an entity does or does not meet the definition of "not-for-profit entity" specified in s 25-5(3)(a) and qualify as a "charity" as specified in s 25-5(5).

(c) the proposed governance standards do not truly deal with matters of governance but have the purpose and effect of giving the ACNC power to determine whether activities are in its view eligible, thus subverting the power of the legislature and the courts.

(d) the same considerations apply to the as yet unreleased "external conduct standards" referred to in s 25-5(3)(b).

2.4 The problem is not simply that the executive arm of government wishes to take tax concessions for charities outside the jurisdiction of the courts, but that the Commonwealth lacks constitutional power with respect to State NFPs such as incorporated associations and charitable trusts. The Senate Economics Committee recommended in 2008 that a referral of power from the States was desirable to bring incorporated associations under a national scheme. That report did not consider the situation of charitable trusts, but if it had, the recommendation would have been even more applicable. The application of the ACNC Act and proposed Regulations to charitable trusts is unclear and will create unnecessary uncertainty, and so should not proceed until there has been an appropriate referral of power from the States.

2.5 In relation to charities incorporated as companies limited by guarantee under the *Corporations Act*, the proposed reforms and governance standards are focussed only on providing the ACNC with sanctions against companies if there are breaches by directors of their duties to the company. The mechanism adopted is to "turn off" statutory directors duties under the *Corporations Act* and impose corresponding obligations <u>on the company</u> under the ACNC Act and Regulations. However, this leaves companies and directors in a state of uncertainty about the duties of directors to companies, the rights of companies in the event of breach of duties, and the insurance and indemnity implications. The application of the proposed Regulations to companies limited by guarantee creates unnecessary complexity and uncertainty and should not proceed in its present form.

2.6 The proposed Regulations in most respects do not deal with matters that are truly concerned with governance, and should not be approved by parliament as the apparent purpose and effect is to give the ACNC an impermissible delegation of statutory power to determine eligibility criteria for registration and continued registration under the ACNC Act.

2.7 The proposed Regulations should be assessed by reference to the criteria that have been put forward for their adoption. The proposed standards fail objectively to satisfy those criteria and will be seen to be unnecessary, complex and ineffective. In particular, it has been frequently stated by proponents of NFP reform that the standards will implement the principle of "proportionality", i.e. will allow compliance to appropriate degrees by different charities having regard to size, nature of funding, risks inherent in activities, and the identity of those who benefit from the activities. The proposed standards do not achieve this objective. The ACNC may well intend to enforce compliance having regard to those matters, however, it is undesirable, if charities are to understand the compliance burden they bear, that "proportionality" be a matter of administrative discretion rather than clear specification in the standards.

2.8 The ACNC Act and proposed Regulations expose charities to the risk of registration (and tax concessions) being withdrawn by administrative fiat. There is a need for much stronger protection than the specification in s 35-10 of the ACNC Act that the Commission must consider, and give unspecified weight to, the extent to which adverse decisions may affect the welfare of members of the community that receive "direct benefits". There should be a culpability test that considers the impact on innocent third parties who make contributions to the charity and to the wider detriment to the public from being deprived of the benefit of the charity's activities, e.g. the availability of benefits from other sources.

2.9 The following paper sets out detailed matters in support of the recommendations and submissions above.

3. NATURE OF CHARITABLE ACTIVITIES

3.1 The writer has experience over many years in acting for charitable entities, including Australian companies, overseas companies carrying on activities in Australia, trusts and incorporated associations, which are tax exempt and deductible gift recipients. This experience concerns areas of charitable activity such as medical research and other activities beneficial to the community. The essential characteristics of these charitable entities are:

(a) they are staffed by people who are passionate about improving the welfare of society;

(b) they typically address global problems in collaboration with similar entities overseas;

(c) they are working in areas where Australian government activity or support is lacking or limited;

(d) their work is chronically under-funded;

(e) they are supported in some cases by overseas charities such as the Wellcome Trust (UK) and the Gates Foundation (USA) and agencies such as the World Health Organisation and the National Institutes of Health (USA);

(f) directors and trustees are unpaid volunteers who are subject under current law to onerous duties and responsibilities to ensure an adequate flow of funding; and

(g) funding is typically spent as it is received.

3.2 Charitable entities which are public companies are already subject to onerous public accountability requirements. If there is truly a need for greater accountability and transparency for charities than for other public companies, this can be achieved without adding unnecessary complexity to the current legal regime.

3.3 It is not necessary for those purposes, and it is undesirable, to expose charities and their directors and trustees to the risks of business and operational judgments being second-guessed after the event by regulatory officials who might have a different opinion. The proposed governance standards take us into this unnecessary and undesirable area.

3.4 In the field of charitable endeavour, Australia is not an island. Parochial and isolationist policies focussed on restricting the cost to the revenue of tax concessions may be counter-productive if they adversely affect the standing of Australian charities in the global community.

4. ASSESSMENT CRITERIA

4.1 The proposed governance standards should be judged according to the objectives that have been put forward for their adoption:

(a) To prescribe standards that must be complied with in order to retain tax concessions. There is no question here that parliament may impose whatever conditions it wishes on tax concessions (within the limits of the Commonwealth's constitutional powers). Nevertheless, there is a need for certainty and transparency. Taxation policy, and change in taxation policy, should be addressed squarely and not indirectly by unintended consequences arising from vague and uncertain conditions. Charities whose work has been recognised for many years as providing public benefit should not be exposed to the risk of losing taxation privileges through the imposition of vague and uncertain conditions. Laws must have sufficient certainty to be capable of application by the courts, bearing in mind that it should be the courts rather than the executive arm of government that will determine how the law applies to the facts and circumstances of particular cases. The experience of the last 10 years shows that the ATO has been largely unsuccessful in persuading the courts to adopt the ATO's interpretation of the general law definition of charity, which is still to play out with regard to the proposed statutory re-definition of "charity" (see John Tretola "Tax Exempt – It's not about tax but charity," (2010) *Revenue Law Journal*). The ACNC Act attempts to take certain matters, e.g. the removal of trustees, from the jurisdiction of the courts and place these within the administrative discretion of the executive arm of government. Whether this will be successful or is desirable remains to be seen.

(b) To prescribe standards that underpin public trust and confidence in charities. There does not appear to be any evidence that there is a lack of public trust and confidence in charities established under the *Corporations Act*, which generally are bound by the same governance standards as public companies. Nor is there any evidence that the regulation and oversight of charitable trusts under State legislation and by State Attorneys-General provides cause for public concern. A necessary element of public trust and confidence is that charities remain independent of the executive arm of government to promote the charitable purpose according to the business judgment of those involved in the charitable work, and so best placed to make such decisions. Another necessary element is that the power to determine whether charitable entities and their directors or trustees have complied with law should remain vested in the courts rather than the executive arm of government.

(c) To centralise and simplify governance, thus reducing red tape, complexity and compliance costs arising from ad hoc governance requirements. This fundamental objective is stated in Treasury's December 2011 consultation paper entitled "Review of not-for-profit governance arrangements" (¶3-4). It is reiterated in ¶2.2 and ¶2.3.3 of the present consultation paper, which states the objective in more equivocal terms – to "deliver an element of consistency". This is not a separate matter that can be relegated for subsequent consideration but is a key criterion by which the proposed

governance standards must be judged. Reference will be made in this submission, where appropriate, to the COAG report of January 2013 entitled "Regulatory Impact Assessment of Potential Duplication of Governance and Reporting Standards for Charities". According to ATO data in Appendix L to that report, if we leave aside unincorporated clubs and associations, and incorporated associations, the most common forms of charities are public companies limited by guarantee and trusts established by will or *inter vivos* trust instrument, both companies and trusts appear to be approximately equally numerous.

(d) To centralise regulatory powers in the national regulator, e.g. powers regarding asset protection, suspension and removal of directors and trustees, registration and de-registration, enforcement of governance rules, investigative processes, enforcement powers including penalties and fines, mandating compliance activities, and dispute resolution (see Treasury's December 2011 consultation paper, ¶13.6). While the government anticipates some transition over time, the objective is to avoid inefficient duplication of regulation in this process (¶22-23). A major flaw in the achievement of this objective is that enforcement powers are generally limited to "federally regulated entities" (see ¶2.3.5, which does not explain how the ACNC will work with other regulators, or indeed who these may be). There is an important principle recognised under company and trust law: judges do not second-guess the business judgment of company directors or trustees (see s 180(2) of the Corporations Act, and in relation to trustees, eg *Karger v Paul* [1984] VR 161). Presumably the basis for this principle is that judges are not equipped by training or experience to operate companies or trusts and/or that such operations would grind to a halt if business judgments were liable to be overturned by the courts. To interfere with this principle in the case of charities would conflict with objective 2 above. There is no reason to believe that the executive arm of government is any better placed to second-guess the business judgment of company directors or trustees.

(e) To apply "principles-based standards" differently to different kinds of charitable entities (¶2.3.2 of the present consultation paper) and "proportionately" to different charities having regard to size, nature of funding, risks inherent in activities, and the identity of those who benefit from the activities (¶2.3.4). This objective conflicts with, and may require a trade-off against, objective 3 above. The present, largely judge-made, standards applying to company directors and trustees are "principles-based standards" and it is the application of such standards by judges according to the facts and circumstances of the case that lead to the criticism of current standards as complex and ad hoc. It is suggested that objectives 1, 2 and 4 above should prevail, i.e. charities and their directors and trustees require certainty and independence in order to be able to operate effectively.

5. CONSTITUTIONAL FRAMEWORK

5.1 The United Kingdom model for regulation of charities has been preferred in recent Australian discourse without any overt appreciation of the significant differences between the UK and Australian constitutional frameworks. For example, the December 2008 report of the Senate Standing Committee on Economics entitled "Disclosure Regimes for charities and not-for-profit organisations" expresses a preference for the UK model (¶6.35). However, that report did not acknowledge the constitutional differences and limitations, noting only that the Australian model would differ in regulating both charities and other NFPs (¶6.27).

5.2 The report's discussion of legal structures omitted any discussion whatsoever of trusts. Charitable trusts may be created by will or by *inter vivos* trust instrument and are governed by State law, both the general law and legislation, which recognise the long-established

jurisdiction of the State courts and the State Attorneys-General in the regulation of charitable trusts. The UK Charity Commission is established by legislation that modifies the general law definition of charity and vests in the Commission certain powers in relation to charitable trusts that in Australia are vested in State courts and the State Attorneys-General.

5.3 Another area of State jurisdiction is the legislation providing for incorporated associations. The 2008 Senate committee report recognised that a referral of powers from the States to the Commonwealth would be necessary for effective national regulation of incorporated associations (¶6.27). Had the committee turned its mind to the situation of charitable trusts the same conclusion would have been compelling, namely, that a referral of powers from the States to the Commonwealth would be necessary for effective national regulation of charities based on the UK model.

5.4 The COAG January 2013 paper "Regulatory Impact Assessment of Potential Duplication of Governances and Reporting Standards for Charities" misses the point in stating that there is no duplication of compliance obligations for incorporated associations and charitable trusts as "they are not subject to State or Territory legislation" with respect to permitted purposes and duties of directors and trustees (¶31 and (¶51). This is incorrect and misleading because the situation is not fully explained. Charitable trusts are subject to State law, both the general law and statutes which govern permitted purposes, powers and duties of trustees. Both the general law and statutes give the State courts and the State Attorneys-General powers to regulate charitable trusts, including to remove and replace trustees (the statement regarding these laws at p. 74 is likewise incorrect and misleading). The paper does not consider the regulatory impact of trustees being required to alter their trust duties under express trust terms and both the general law and statutes to adopt the proposed governance arrangements which may conflict with State laws. The suggestion at p. 66 of the paper that no change is required to State or Territory legislation dealing with the terms of a charitable trust is incorrect and misleading because it does not address the implications of conflict between Commonwealth and State laws on the subject. Likewise, the discussion at p. 72 of the general law and the fundamental 1995 reforms of statutory duties of trustees with regard to investment understates the issues arising from the proposed financial management standard.

5.5 The Commonwealth has expressed an intention to change the general law definition of charitable purposes. While it may do so for the purposes of the Commonwealth, the constitutional issues, and consequences of differences between Commonwealth and State laws regarding permitted charitable purposes remain to be addressed and should not be overlooked in the present exercise. These issues do not arise under the UK model for charities regulation.

5.6 The drafters of the ACNC Act are well aware of the significance of State laws, as s 180-20(5) purports to override State law by giving the Commissioner of Taxation direct rights against trust assets.

5.7 Neither the COAG regulatory impact assessment nor the Treasury consultation paper squarely address the constitutional issues. However, the latter implicitly acknowledges the difficulties in a footnote to the effect that the ACNC's enforcement powers are generally limited to "federally regulated entities" (p. 9 fn. 2). These entities are defined in s 205-15 of the ACNC Act by reference to trading or financial corporations within the scope of paragraph 51(xx) of the Constitution. Thus the vast bulk of testamentary charitable trusts and *inter vivos* trusts which have individual trustees, or sometimes individual trustees and a public trustee company, would fall outside this definition. Further, it is not at all clear that NFPs can be regarded as trading or financial corporations within the scope of the Constitution.

5.8 The ACNC Act also anticipates a constitutional problem in so far as the Act may deprive parties of rights without compensation: s 185-10 obliges the Commonwealth to provide reasonable compensation. We may speculate as to what this is intended to cover. For example, companies limited by guarantee are deprived of certain rights against directors for breach of duty. Perhaps this section is intended to compensate them. If so, the regulatory impact should be considered.

5.9 With respect, the Senate Economics Committee was correct in its 2008 report when it expressed the view, in the context of the purposes and function of its report, that a referral of powers from the States to the Commonwealth would be necessary to harmonise the regulation of different entities (see ¶7.59). The Committee under-estimated the constitutional implications of adopting a national regulatory framework based on the UK model. These issues have not been addressed adequately or at all in the legislative model subsequently developed, and in the process of being developed, by the Commonwealth 5 years later. Not only have they not been addressed, the omission underlies the proposed governance standards, which will create complexities and problems that ought to be prevented from arising.

6. REGULATORY FRAMEWORK

6.1 The December 2012 consultation paper states that certain statutory duties of directors of charities incorporated as companies (generally limited by guarantee) under the Corporations Act will be "turned off" (¶2.3.2). What remains, however, are the general law duties of company directors (see eg *Daniels v Anderson* (1995) 37 NSWLR 438), which are not "turned off". The Commonwealth does not propose to "turn off" the duties of trustees under State law, both the general law and statutes, which govern the duties of trustees (see p. 22 of the paper). This is unexplained, but presumably is due to the constitutional limitations mentioned above. That is, while the governance standards apply whether or not charities are federally regulated entities, the Commonwealth presumably lacks power to "turn off" duties of trustees under State law to ensure a level playing field between companies and trusts.

6.2 What is "turned on" is the proposed new governance regime, which strangely obliges the company or charitable trust to take reasonable steps to ensure that its board of directors or trustees comply with the governance standards. The paper states that the proposed governance standards are intended to be "substantially the same" as the Corporations Act duties "turned off", then strangely states that the governance standards are intended to impose obligations on the *charitable entity* "rather than" the directors of a company or trustees of a trust (p. 22). As companies can only act through their board of directors, the result is to impliedly impose obligations on directors without the specific statutory defences and "business judgment" rule applying under the Corporations Act (these issues are discussed further in paragraphs 9.14 and 9.15 of this submission below). As a trust is not a legal entity, obligations on the trust can only take effect as obligations on the trustees. This is recognised in s 180-20 of the ACNC Act.

6.3 The result would appear to be an unnecessarily complex overlay of duties. The apparent purpose is to ensure that the charity itself can become liable to enforcement action by the ACNC as a result of breach of the governance standards. If that is the purpose it makes no sense to subject the charity to liability as a result of breaches of duty by directors or trustees. Imposing liability on the charity, which in the ultimate form could mean loss of tax exempt status, not only penalises the charity but all donors and volunteers who have contributed to it. That would seem a wholly inappropriate remedy even if a director or trustee breaches personal duties.

6.4 Take the equivalent situation of a company director who breaches a duty to the company. It would not be suggested that the appropriate remedy would be for ASIC to prosecute the company, and potentially de-register the company. The *Corporations Act* gives ASIC power to prosecute the directors, in addition to the remedies open to the company against the directors (see eg *ASIC v Hellicar & Others* [2012] HCA 17).

6.5 Apparently the imposition of governance duties on the charitable entity itself is done without regard to the liability of directors and trustees of charities for breaches of duties. However, by virtue of associated changes to the *Corporations Act* seemingly directors of companies are relieved of duties while trustees are not. Where this leaves companies and trusts in relation to rights of compensation against defaulting directors and trustees is not clear. The impact on rights of indemnity and insurance also remain to be seen.

7. USEFUL PRECEDENT

7.1 The Superannuation Industry Supervision legislation provides a useful precedent for management of issues arising from Commonwealth regulation of trusts. To bring such trusts within Commonwealth constitutional power, the tax law is used to require as a condition of tax concessions that the trustee either be a corporation or that the trust provide pension benefits, thus founding the prudential and operating standard imposed by the SIS legislation on several heads of power.

7.2 The position regarding NFPs is not so simple, as the Senate Committee report of 2008 shows, with respect to incorporated associations. There a referral of power from the States was considered necessary. It is submitted that a referral of powers from the States to the Commonwealth with regard to charitable trusts would avoid the complexities and contortions required in the proposed governance standards. In the case of the ACNC Act, the Commonwealth has not chosen to bring charities under available heads of Commonwealth power, but to apply the law differently to some charities than for others, due to constitutional limitations. Unequal discrimination in the application of the law is undesirable.

7.3 Nevertheless, the example of the SIS legislation is instructive with regard to:

(a) sole purpose test – this requires careful thought as charitable purposes are broad, and a charity should not be narrowly restricted from carrying out a wide range of activities which fall within the definition of charitable purposes (see e.g. SIS Act s 62 which permits a wide range of core and ancillary purposes). The ACNC Act and proposed Regulations do not address charitable purposes or charitable trusts, which leaves the position of charitable trusts (and companies with charitable purposes) unclear.

(b) imposition of operating standards on registered charities – this can be done as a condition of registration and is quite a separate matter from duties of directors and trustees (see e.g. SIS Act s 31). These conditions should be specified in the ACNC legislation, not left to regulation-making power.

(c) licensing of persons eligible to act as trustees – currently anybody may act as a company director (subject to disqualification of certain person's udder the Corporations Act) or trustee of a charitable trust (subject to the powers of the courts to remove trustees in certain circumstances). The licensing of superannuation trustees is unusual but justified in the light of the large sums of money under management comprising the retirement savings of individuals (see SIS Act s 29D).

(d) the appropriate method of imposing duties on trustees (if it is demonstrated to be necessary to add to the duties under general law of the States and legislative duties set

out in States trustee legislation) is to require provisions to be inserted in trust instruments (see e.g. SIS Act Part 6). Unlike superannuation funds, charitable trusts can be created by will of deceased persons. Amending trust terms is not so easy in this case and legislative authority would be required to obviate the need for trustees of charitable trusts to obtain court approval under existing law to modify the trust terms.

(e) trustee liability – to encourage trustees to undertake the onerous duties of trustee, legislative recognition should be made with regard to trustee indemnity and exemption provisions (see e.g. SIS Act s 56, a trustee is entitled to indemnity unless he or she fails to act honestly or intentionally or recklessly fails to act with the requisite degree of care).

(f) a specific example of the two preceding points is the regime regarding investment duties – see SIS Act ss 52(1)(f) and 55(5). Trustees are protected against claims for investment losses if they have formulated an investment strategy having regard to the specified relevant considerations. The purpose of these provisions is to ensure that business judgments are not liable to be second-guessed. Similar provisions exist under State law (see e.g. ss 8 and 12C of the *Trustee Act* 1958 (Vic)).

(g) power to suspend or remove trustees (see e.g. SIS Act s 133) is a necessary power to protect members superannuation benefits.

(h) consequences of the regulator withdrawing registration – in recognition that this would cause loss to innocent parties, the potential harm needs to be considered (see e.g. SIS Act s 42(1A)). This is a much stronger provision that the specification in s 35-10 of the ACNC Act that the Commission must consider, and give unspecified weight to, the extent to which adverse decisions may affect the welfare of members of the community that receive "direct benefits". Regard should be had to the impact on innocent third parties who make contributions to the charity and to the wider detriment to the public from being deprived of the benefit of the charity's activities, e.g. the availability of benefits from other sources.

8. CONSEQUENCES OF CONTRAVENING GOVERNANCE STANDARDS

8.1 The consequences are far-reaching:

(a) Registration as a charity (and entitlement to tax concessions) may be revoked (see s 35-10). As mentioned above, there is no "culpability provision" to protect innocent contributors to or recipients of the charity's benefits. There is no "proportionality" requirement. While the discussion paper states that the various enforcement powers "allow" the ACNC to take a proportionate response (¶2.3.5), there is no legal requirement to this effect in the legislation.

(b) The ACNC may give directions, in which case the company or trustee must comply by virtue of s 85-15. That section does not address the impact on third parties, or on the duties of directors and trustees under the general law. These powers may place charities and their directors and trustees in conflict with duties under the general law and other legislation, e.g. the States Attorneys-General and the courts have the power to give trustees directions as to how to exercise trust powers and duties. In this event trustees are protected by the State Trustee Acts. However, there is no similar protection conferred by the ACNC Act.

(c) The powers of the ACNC to suspend or remove directors and trustees of a charity apply only to federally regulated entities (s 100-5).

9. SUBMISSIONS ON THE PROPOSED STANDARDS

9.1 Do the standards comply with s 45-10 of the ACNC Act? It has been repeatedly stressed by Treasury that the governance principles "will provide flexibility so that any requirements are proportional", i.e. will differ for large and small NFPs (see e.g. the December 2011 consultation paper on governance arrangements, p. 1 point 6). The simplified outline in proposed Reg 45.1 states:

> the steps that a registered entity will need to take to comply with the standards will vary according to its particular circumstances, such as its size, the sources of its funding, the nature of its activities and the needs of the public (including members, donors, employees, volunteers and benefit recipients of the registered entity).

9.2 That outline is incorrect. S 45-10(2A) of the Act provides:

> the principles mentioned in [subparagraph (2)(b)(ii)] may reflect the size of the entity, the amount and nature of contributions to the entity and the nature of the activities undertaken by the entity in pursuit of its purposes.

9.3 The outline does not, of course, have any legal force. However, the problem is not merely that the outline mis-states the provisions of the Act. The proposed standards do not comply with s 45-10, which does not say that a charity may take steps that are appropriate according to its circumstances to comply. Section 45-10(2) provides that the standards may require specified outcomes and specify principles as to how to achieve those outcomes. S 45-10(2A) is set out above. It permits the principles set out in the standards to reflect the matters described, but definitely does not have the effect described in the simplified outline. The proposed standards do not therefore provide for "proportionality" in the manner it has been represented to operate.

9.4 Section 45-10(2)(b) is problematic in that due diligence standards applicable to directors and trustees under the general law and legislation do not attempt to specify outcomes but inputs, i.e. the standard of care required on carrying out functions. Thus, for example, a lawyer cannot undertake to win his case (i.e. achieve an outcome) but is bound to comply with a standard in carrying out his work (i.e. to use due care and diligence). The same applies to directors and trustees under general law and statutory standards of due care. While the expression in s 45-10(2A) of the principle of "proportionality" is useful, its application is limited to subsection (2)(b) which is inherently unworkable. The ACNC Act should be amended to ensure the standards enshrine "proportionality".

9.5 **Standard 1 – Purposes and NFP nature of a registered entity**. This standard (45.5) is based on a misconception that, absent the standard, charities (and their directors and trustees) are not bound to pursue the charity's purpose. The position is slightly different for companies and trusts:

(a) companies for many years have not spelt out their purposes in constitutions. This does not mean they do not have purposes. Companies which are NFPs generally spell out purposes. However, the old law that limited a company's powers by reference to its purposes is long gone because of the problems it caused for third parties dealing with a company which might later be found to have been acting "beyond power". Under current law a company has power to do anything an individual could do. It is undesirable to return in any way to the old position under which actions might be invalid if "beyond power". Directors nevertheless can be liable for breach of duty in applying the company's funds contrary to its purposes (or contrary to the interests of the company as a whole).

(b) trusts are strictly regulated by the terms of the trust instrument and powers conferred on the trustee by the trust instrument and the general law and statutes of the State concerned. Trustees will be liable for breach of duty in applying the trust funds contrary to purposes permitted by the trust instrument.

9.6 Paragraph 45.5(2)(a) is based on a misconception that, absent the standard, an instrument establishing a charity need not demonstrate a charitable purpose and not-for-profit character. A charitable trust will not qualify unless the instrument demonstrates a purpose which is charitable at law. A not-for-profit company must, under the *Corporations Act*, prohibit distributions to the members. This proposed standard duplicates other legal requirements, in different words, and so will only create uncertainty. Further, it repeats an entry condition for charitable status that has no place in governance standards.

9.7 Paragraph 45.5(2)(b) is unobjectionable but unnecessary, as demonstrated by the note to the standard, which indicates that a registered charity's purposes will be a matter of public record.

9.8 Paragraph 45.5(2)(c) is based on a misconception that, absent the standard, a charity need not comply with its governing instrument. This standard duplicates other legal requirements and obligations on directors and trustees, in different words, and so will only create uncertainty. Further, it repeats an entry condition for charitable status that has no place in governance standards.

9.9 **Standard 2 – Accountability to members**. This standard (45.10) is based on a misconception that, absent the standard, charities (and their directors) are not accountable to members. Companies limited by guarantee are public companies bound by all the reporting requirements of the *Corporations Act*. As public companies, the members have the ultimate right to remove and appoint directors. The rights of members are codified and protected by the *Corporations Act*. The requirement of paragraph 45.10(2)(a) that a company "take reasonable steps to ensure it is accountable" to members, with the object of "transparency" is meaningless or at best unclear as to the difference between this requirement and the *Corporations Act*. Note 1 to the draft provision states that reasonable steps "include" holding annual general meetings, providing annual financial reports to members and providing for election of directors. These matters are already provided for under the *Corporations Act*. The effect of such a standard would be merely to create uncertainty as to what more must be done. The consultation paper at p. 14 states that if charities are complying with current obligations they will satisfy the proposed new standards. That is incorrect. The proposed new standards create uncertainty by replacing current specific provisions with vague and uncertain requirements.

9.10 Paragraph 45.10(2)(b) requires a company "take reasonable steps to ensure … members have an adequate opportunity to raise concerns about governance". Note 2 to the draft provision states that reasonable steps "include" holding a question and answer session at the AGM and providing an opportunity for members to propose and vote on resolutions. Members already have the right under the *Corporations Act* to propose and vote on resolutions, and to convene general meetings for that purpose. This standard is completely unnecessary and serves no useful purpose.

9.11 **Standard 3 – Compliance with Australian laws**. The objective of this standard (45.15) is garbled and illogical. Compliance with Australian laws is a given for all citizens. Whatever the purpose of particular Australian laws may be, they have nothing to do with ensuring ongoing operations of charities or safety of assets. It is illogical to suggest that compliance with the laws that bind everyone anyway can contribute it any meaningful way to ensuring ongoing operations of charities or safety of assets. The standard simply subjects charities to double jeopardy and has nothing to do with governance. Should any citizen break the law

then the remedy is within the province of existing law enforcement agencies. Pending investigation and conviction any citizen is entitled to the presumption of innocence. The ACNC should not be given power under this standard to second-guess law enforcement agencies and subject a charity to sanction by virtue of conduct that "may" be dealt with under other laws.

9.12 **Standard 4 – Responsible management of financial affairs**. This standard (45.20) is based on a misconception that, absent the standard, charities (and their directors and trustees) are not bound to manage the resources of the charity in a responsible manner. As noted above, companies and their directors and trustees are bound by strict duties under the *Corporations Act* and State law. The proposed standard is unnecessary and would create uncertainty as to the effect on existing legal duties. In the context of standards that may expose charities to the risk of revocation of registration and/or removal of directors and trustees by administrative action of the ACNC, "reasonable steps" is too vague and uncertain.

9.13 **Standard 5 – Suitability of responsible entities**. This standard (45.25) is misconceived, apparently an attempt to overcome an error in drafting the ACNC Act: the proposed "governance standard" gives the ACNC power to disqualify persons from acting as directors or trustees. This is not an appropriate subject matter for regulations made under the ACNC Act. If the ACNC wants these powers they should be endorsed by parliament in the Act. There is adequate provision under the *Corporations Act* for persons to be disqualified as directors, and under State law for persons to be removed as trustees by the courts if there is a risk to the trust fund.

9.14 **Standard 6 – Duties of responsible entities**. This standard (45.30) is based on a misconception that, absent the standard, directors and trustees of charities are not bound by fiduciary duties. As noted above, the proposal is that *Corporations Act* duties be "turned off". This nevertheless leaves general law duties, including fiduciary duties in place. Trustees are of course already fiduciaries. The standard, however, goes beyond the fiduciary duties (to act gratuitously and to avoid conflicts of interest):

(a) Paragraphs 45.30(2)(a) and (b) inclusive deal with the standard of care required of a director or trustee (which is not a fiduciary duty), in different words to the formulation of the standard of care applying to directors under the Corporations Act and the general law and statutes applying to trustees under State law. It is highly undesirable to alter these provisions, which are more than adequate at present. It is even less desirable to overlay this vague and uncertain prescription of new duties over existing legal duties.

(b) Paragraphs (c) to (e) concern conflicts of interest. These provisions are inconsistent with the *Corporations Act* and the general law and statutes applying to trustees under State Law. The *Corporations Act* permits conflicts of interest so long as they are disclosed at board meetings and conflicted directors do no participate and are not present unless the other board members agree. The introduction of a requirement to disclose conflicts to members is novel and problematic because there is no established means of communicating such matters to members, e.g. must each member be informed at the same time as the board? Why is this necessary if the conflicted person takes no part in the decision in question? Conflicted trustees are not permitted to act unless the trust instrument so provides.

(c) Directors of companies are entitled to remuneration (unless in some cases companies limited by guarantee prohibit remuneration). Trustees are not permitted to remuneration unless the trust instrument so provides. The proposed standard thus conflicts in varying degrees with the *Corporations Act*, State trust law and the

provisions of trust instruments. Careful thought needs to be given to prohibiting remuneration of directors and trustees (if that is the intent by prescribing fiduciary duties). Given the added complexity and burdens on directors and trustees under the ACNC Act and governance standards, remuneration should become more appropriate. The impact of the proposed governance standards and indemnity and insurance (and the ability of the charity to pay insurance premiums) is unclear. The *Corporations Act* makes very specific provision for these matters, which will be cast into doubt.

(d) Paragraph 45.30(2)(f) effectively prohibits insolvent trading. It thus duplicates provisions of the *Corporations Act*. There is no need for it in the case of trustees, because they are personally liable in any event for liabilities they incur, subject to their right of indemnity out of trust assets.

(e) Although the discussion paper states that the standards apply only to charities, and do not impose burdens on directors and trustees, clearly the effect of 45.30 is to impose by implication fiduciary duties, or duties corresponding to fiduciary duties, on directors and trustees. The "protections" however, apply only to the charities themselves, not to the directors or trustees (see paragraph 45.100). The "protections" provide defences for the charitable entity itself, thus potentially shielding without discrimination directors who have breached their duties and those who have fulfilled their duties. The point to note about defences is that the burden of establishing the defence falls on the person seeking to rely on it, i.e. the charitable entity and/or the director or trustee.

9.15 In relation to specific "protections":

(a) Protection 1 would need to acknowledge the protections available to trustees under the general law and statutes of States, e.g. acts or omissions of agents, reliance on directions of the court, etc. It can be anticipated that under the proposed new regulations trustees may more often in future need to seek directions from the courts. Division 85 is not appropriately drafted for the ACNC to replace the functions of the court in giving directions to trustees.

(b) Protection 2 does not expressly adopt the business judgment rule. There should be a clear statement that business judgments are not to be second-guessed by the ACNC, let alone form the basis for sanctions such as revocation of registration. There is a further problem in that the duty of care established by standard 6 overlaps with investment duties under standard 4. As mentioned above, this is addressed specifically in the Trustee Acts (and corresponding provisions of the SIS Act).

10. RECOMMENDATIONS

10.1 The apparent purpose and effect of the ACNC Act and proposed Regulations is to remove the determination of "charitable purposes" from the province of the courts and legislature and make it the subject of administrative fiat by the executive arm of government. This is undesirable if not unconstitutional.

10.2 The proposed governance standards do not truly deal with matters of governance but have the purpose and effect of giving the ACNC power to determine whether activities are eligible, thus subverting the power of the legislature and the courts.

10.3 The application of the ACNC Act and proposed Regulations to charitable trusts is unclear and will create unnecessary complexity and uncertainty, and so should not proceed until there has been an appropriate referral of power from the States.

10.4 By "turning off" statutory directors duties under the *Corporations Act* and imposing corresponding obligations on the company under the ACNC Act and Regulations companies and directors are left in a state of uncertainty about the duties of directors to companies, the rights of companies in the event of breach of duties, and the insurance and indemnity implications. The application of the proposed Regulations to companies limited by guarantee creates unnecessary complexity and uncertainty and should not proceed in its present form.

10.5 The proposed Regulations fail objectively to satisfy the criteria that have been put forward for their adoption. The proposed standards are unnecessary, complex and ineffective. In particular, the standards fail to implement the principle of "proportionality", i.e. to allow charities to take compliance steps to the extent that they are appropriate having regard to size, nature of funding, risks inherent in activities, and the identity of those who benefit from the activities. It is inappropriate to leave "proportionality" to the administrative discretion of the ACNC rather than to have it clearly spelt out in the ACNC Act and Regulations.

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8 February 2013