



## Charities & Insolvency Trustees – Walking the line

Frequently charities make the headlines for the wrong reasons. The impact of the recent scandal that affected Oxfam was immediate and will have far reaching consequences. One of the effects will be the impact on its ability to fund its future work. **Oxfam** is a large complex charity which has access to the necessary financial advice to ensure that it is able to continue with its charitable work in future. In the case of smaller charities they may not have trustees with the necessary financial skills to deal with such crises and their effect on the charity's solvency. In this article we look at some of the financial considerations that trustees of incorporated charitable companies should take into account when faced with challenging conditions.

Incorporated charities are usually formed as companies limited by guarantee and as such they have a separate legal identity. As in the case of any other company, the charity will have its directors although they will be referred to as trustees. They fulfil the same role and carry the same responsibilities.

The way in which charities fund their activities is very different from commercial organisations. They rely on the provision of funding from benefactors, government bodies and other charitable institutions. The methods by which a charity receives its funding will potentially affect the position of the charity in the event that its solvency comes into question. In particular, will the funding assets that have been provided by third parties be available to meet the charity's creditors' claims in the event of its insolvency? The answer to that question will be extremely important to trustees in deciding whether at any given time the charity is solvent or insolvent.

### **Funding – Gifts and Legacies**

Legacies are an important part of a charity's funding and can range from modest gifts to substantial assets. Often the testator will make statements either in a will or in a letter or communication as to their wishes in relation to the gift. Careful consideration of the terms of the will and any related documentation will indicate whether or not such statements are express conditions which restrict the way in which the asset may be used or whether they are merely an expression of a desire without any binding effect. In the case of a testator who left a portrait by Stubbs to a charitable company **"provided we can find somewhere suitable to hang it at Barlaston"** this did not create a charitable trust in respect of the Stubbs portrait.

Charities often receive their assets in the form of gifts. That occurred in the case of the **Wedgwood Museum Trust Limited (in administration) [2011] EWHC 3782 (Ch)** which ultimately went into administration. The administrators sought directions from the Court as to whether specific gifts and legacies could be used to meet the claims of creditors of the company. Previously the Wedgwood Trading Company had gifted its collection of Wedgwood to the Museum. The Deed of Gift provided that the named individuals who received the collection by delivery were to **"hold the same on trust for the Wedgwood Museum Trust Limited"**. Whilst it was argued that the Museum Company held the collection as trustee of the charitable trusts for which it was formed, the Court rejected that notion and confirmed that charitable companies do not hold their assets on a trust for their charitable objects. In the case of a charitable company it will hold its assets outright both legally and beneficially. Whilst the company could create separate charitable trusts, there was no separate charitable trust in relation to the collection held by the Museum. This was the case even though the company's title included the word "trust".



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### How to spot a trust

The question of whether a trust was created over donations received from the public was considered in **Re Dove Trust [2014] EWHC 2507 (Ch)**. In that case the public were invited to make donations via a website to the Dove Trust for the benefit of other charities or good causes of their choice. The court considered the factors that would identify the existence of a trust as follows:

- (a) Whilst it is not necessary to use the word “trust” the three certainties “of words subject matter and objects must be satisfied”
- (b) Where money is given to a recipient to be paid to a third party and it is not intended that it shall be at the free disposal of the recipient it is likely a trust will arise
- (c) A requirement for the recipient to hold the money in a separate account will be a strong pointer in favour of the existence of a trust
- (d) The court is more likely to find that a trust was intended in a charitable context
- (e) Whether the trust is an express trust for a third party or a **Quistclose** trust in favour of the transferor will depend upon whether it was contemplated that there was a real risk that the purpose for which the money was paid might fail.

In the **Dove Trust** case the court found that a trust had been established in relation to the donations held by the charity. Where a company does hold assets subject to a specific trust, then those assets will not belong to the company and will not be available to its creditors in the event of insolvency.

### Funding – Permanent Endowments

Charities are often funded by permanent endowments. A permanent endowment is the devolvement of an asset on an organisation which it must continue to hold intact in its entirety but may use the interest or income generated by the asset for its charitable purposes. A charity incorporated as a company cannot hold a permanent endowment as part of its corporate property.

### Funding – Grants

Many charities rely on funding from governments, local authorities and other organisations including charities. The recent administration of the **Hastings Pier Charity** arose as a result of its failure to secure continuing grant funding. Funding will be applied for and if successful will take the form of a grant to the charity, usually with conditions attached to it. Only a careful examination of those conditions will establish whether that funding is held on any specific trust which would in the event of the company’s insolvency mean that the funds were not available to creditors.



### Accounting requirements – Restricted funds

A charitable company will often have specific provisions contained within its Memorandum and Articles of Association as to the use of its assets for charitable purposes. Whilst the company remains solvent the company must act *intra vires* and ensure that its assets are used for those charitable purposes only and for no other purpose. However, once insolvency intervenes the restrictions contained within the company’s Memorandum and Articles fall away and the insolvency regime takes over.

Trustees are required to identify the nature of the funds held and for what purposes in the company’s accounts. This would include identifying restricted funds. These will be funds subject to specific trusts which were either created by the donor or which came about through the way in



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which the funds are raised, i.e. through public appeal or some other legal process. Restricted funds will be identified and often separated from unrestricted funds. The restriction will usually mean that the funds can only be used for the purpose for which they were given and are not at the general disposal of the trustees in exercise of the charity's general charitable purposes. The charity must report such funds appropriately in its financial statements in accordance with accepted accounting principles.

In practice, the question of whether the funds are held in such a way as to escape the claims of creditors is often difficult to determine. Funds may be subject to a condition which means that they are earmarked as restricted, however in the event of insolvency unless a specific trust has been created those funds may, notwithstanding any restriction, be available to meet the claims of the company's creditors.

### The changing role of trustees in troubled waters

Trustees of charities are often highly motivated and dedicated in the pursuit of the charitable purpose of the company in which they are involved. As trustees their role in implementing the charitable objects of the company is often clear. However, when events intervene which place a strain on the company's financial position, the trustees will need to be aware or make themselves aware of the charity's financial position and in particular whether or not it is solvent.

### Insolvency tests

Insolvency comes in two forms. The first is cash flow insolvency, the test for which is the ability of the company to pay its debts as they fall due. The second is balance sheet insolvency where the company's liabilities exceed the value of its assets. Only one test needs to be satisfied for the company to be insolvent. In the normal course of events whilst the charity is continuing to trade successfully, then the valuation of its assets will often be on a going concern basis. Where insolvency threatens, then the continued use of such a basis may no longer be appropriate and in this respect trustees should seek professional advice.

Where the continued existence of the charity is in doubt, liabilities can often increase. Therefore in determining whether or not the company is solvent on a balance sheet basis regard should also be had to additional liabilities which may arise, i.e. redundancy costs, dilapidations claims and professional charges. In addition to that, creditors' claims of a contingent nature, i.e. lease claims, should also be included in any assessment of the company's solvency.

The trustees have responsibilities/duties under the **Companies Act 2006** to act in a way to promote the success of the company. Once the question of possible insolvency arises, the **Insolvency Act 1986** places an additional obligation on trustees to take into account the interests of the company's creditors. The role of the company's trustees assumes this additional responsibility irrespective of whether or not the trustees are fully aware of the position.

### The consequences of trustees getting it wrong

A charity incorporated as a limited company will be subject to the provisions of the **Insolvency Act 1986** and in particular those sections relating to wrongful trading and misfeasance just as the directors of any commercial company would be. The danger of wrongful trading is that trustees may be personally liable for losses incurred during the period of time when the charity continues to trade and the trustees have or should have concluded that the charity could not avoid going into insolvent liquidation. Whilst the possibility of wrongful trading is apparent, in reality it arises infrequently in relation to charities. The important point is that if the trustees are aware of the charity's financial



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position and seek (and implement) advice at an early opportunity, then potential exposure to personal liability under those provisions is significantly decreased.

For trustees it is important to understand the source of the charity's funding and the terms on which it is held. Where the steps mentioned in the above paragraph – **Accounting requirements – restricted funds** have been taken, it is less likely that the assets will form part of the company's assets and be available to the charity's creditors. Attempts to deal with those assets by the trustees in a way inconsistent with the terms of those trusts may also lead to a claim for breach of trust and/or misfeasance. Again it is important to emphasise that such claims are fortunately relatively uncommon.

Trustees of a charity going into insolvent liquidation will be subject to reporting to the Secretary of State for the purposes of possible disqualification under the **Company Directors' Disqualification Act 1986**. If an application for disqualification is made out, then a trustee may find themselves being disqualified from acting as a director of any other companies/charities in which they are involved. The mere possibility of disqualification proceedings, even if it does not result in a disqualification, can have damaging consequences for trustees as can be seen in the case of **Kids' Company**. Disqualification proceedings apply equally to a de facto or shadow director even though they were not appointed formally as a trustee of the company. Camila Batmanghelidjh was the high profile public face of Kids' Company. She was never formally appointed a director of **Kids' Company** but nevertheless has been the recipient of correspondence from the Insolvency Service threatening disqualification proceedings against her.



Trustees of company charities must ensure that they are aware of the status of the funding they receive whether it be in the form of legacies, grants or gifts and in particular whether those assets will, in the event of the charity's insolvency, be available for creditors or may otherwise be protected by specific trusts. Armed with that information and faced with financial difficulties, the trustees must undertake the task of establishing whether or not the charity is solvent or insolvent. The tests for insolvency are technical and may in many cases require the assistance of professional advisors to determine the position accurately. Failure to do so may result in the charity continuing to drift. Trustees of a charity in the twilight period before formal insolvency who do not establish the charity's financial position and its solvency/insolvency can expect to face legal and financial repercussions following the charity's failure.

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### Julian Dobson SOLICITORS

#### *Insolvency Lawyers*

Author: Julian Dobson



1 Frederick Terrace, Frederick Place, Brighton BN1 1AX  
Tel 01273 766 355 Fax 01273 766 350 **email: [info@juliandobson.com](mailto:info@juliandobson.com) Web: [www.juliandobson.com](http://www.juliandobson.com)**

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