GOVERNANCE IN NOT FOR PROFIT ORGANISATIONS IN NEW ZEALAND

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ABSTRACT

Governance has been explored extensively as a concept within the corporate sector. It has not, however, received a similar level of analysis in relation to not-for-profit entities. This paper considers governance within the not-for-profit sector in New Zealand, focussing in particular on the health and disability sector, an area of the community that has undergone significant change in the last 20 years with growth in state funding and in demand for services and corresponding expectations of service provision and accountability.

Not-for-profit entities differ significantly in governance terms from commercial entities. They have broader purposes than the maximisation of wealth and a wider range of stakeholders in comparison to the traditional focus on shareholders of commercial entities. In addition, assessment of performance is more complex, with funders and service recipients having differing perspectives on achievement for an individual not-for-profit.

These competing interests add a layer of complexity to the governance paradigm, commonly described in terms of two dimensions - an internal focus on systems and processes that ensure that the entity is able to achieve its mission and purposes, and an outward dimension that focuses on relationships with stakeholders.

Continuing pressure to ensure financial stability, with limited sources of revenue, combine to pull the governance focus of the not-for-profit closer to that of a commercial entity, creating tension in terms of achievement of mission and purposes.

The argument is presented that the result for the not-for-profit sector must be a governance hybrid, with focus on mission remaining of overriding importance, but with a simultaneous focus on identifying and meeting the expectations of funding stakeholders.
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The concept of governance has attracted increasing academic, corporate and political attention over the past decade, with interest prompted in particular by the spectacular corporate collapses of the 1990s and more recently by the economic fallout from the failures in the banking and finance sector throughout the Western world.

This paper focuses on governance in the not-for-profit ("NFP") sector in New Zealand, with particular emphasis on health and disability service providers. The sector has been the subject of considerable reform over the past 20 years, with a variety of funding and contracting models imposed on providers, in the face of increasing demand for services and increased expectations of accountability to stakeholders.

The role of governance within these NFPs, the impetus for its application and its manifestation within the NFP sector are explored in this paper under the following headings:

1. The nature of the NFP sector in New Zealand.
2. The concept and purpose of governance generally.
3. The concept, purpose and basis of governance in relation to NFPs.
4. Accountability for NFPs and redress for stakeholders of NFPs.
5. Suggestions for reform.
NOT FOR PROFIT SECTOR IN NEW ZEALAND

A Introduction
The economy is commonly divided into three sectors; the public sector, the commercial sector and the not-for-profit or “third” sector. The separate category for the NFP sector recognises that its members are not government owned and that their purposes are not primarily wealth-driven. The sector is an integral part of New Zealand’s social landscape and a significant economic force. For the year ended March 2004 it had a total operating expenditure of $NZ 6.5 billion, contributed 4.9% of GDP and (including volunteers) employed 9.6% of the economically active population – more than the construction, transportation and utilities industries combined.¹

B History of New Zealand NFP Sector
Tennant et al² describe the history of New Zealand’s NFP sector and summarise the radical changes of this sector during the late 1980s and 1990s:³

From the late 1980s, Aotearoa New Zealand reprised its late nineteenth-century role as the ‘social laboratory of the world’, but in reverse, as the state withdrew from many activities.

…Policies supporting community care, devolution, and the culturally appropriate delivery of services assumed the non-profit sector’s ability to replace government activities or responsibilities, albeit with public funding. There was also a need to ensure that the vastly increased amounts of money being transferred to the non-profit sector achieved what was intended, and the public could be assured of accountability.

As a market-driven ethos began to shape the relationship between government and the non-profit sector in the late 1980s, purchase of services through contracts became the preferred mechanism for transferring resources from the state to non-profit organisations and for delivery of services by these organisations.

¹ Jackie Sanders The New Zealand Non-Profit Sector in Comparative Perspective (Office for the Community and Voluntary Sector, Wellington, 2008), 10.
² Margaret Tennant, Mike O’Brien and Jackie Sanders The History of the Non-Profit Sector in New Zealand (Office for the Community and Voluntary Sector, Wellington, 2008).
³ Margaret Tennant, Mike O’Brien and Jackie Sanders The History of the Non-Profit Sector in New Zealand (Office for the Community and Voluntary Sector, Wellington, 2008), 26.
The change in relationship gave rise to concerns around the independence of NFPs reliant on government funding, compliance costs of accountability regimes and increased competition for funding. These concerns resulted in a deterioration of the state-NFP relationship with growing mistrust on the part of the sector, to the extent that in 2001, following consultation with the sector, the government issued the *New Zealand Government (2001) Statement of Government Intentions for an Improved Community-Government Relationship.*

This was followed by the establishment of the Office for the Community and Voluntary Sector within the Ministry of Social Development, whose role is, in part, to liaise and to work in collaboration with the NFP sector.

The most recent development in the sector has been the establishment of the Charities Commission on 1 July 2005, under the Charities Act 2005. The Commission’s role is considered in more detail below, but it describes its intended overall outcome as “a strong, effective charitable sector in which the public has trust and confidence.”

C Classification of NFPs

This paper follows the United Nations International Classification of Nonprofit Organizations (“ICNPO”) in considering NFPs. Specific legislative definitions are considered separately below. The ICNPO classification divides NFPs into 12 categories (health and social services being the two of particular interest to this paper), based on a structural-operational definition of the sector as:

- organized,
- private,
- non-profit-distributing,

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Most New Zealand NFPs fit all criteria, so for the purposes of evaluation of the sector, the definition is useful. The exception is Maori organisations which are largely based on tribal groups and are not necessarily self-contained and private in terms of the definition. Statistics New Zealand has adopted the ICNPO definition for its assessment of the sector for statistical purposes. It excludes entities such as District Health Boards because they are effectively controlled by central government.

The level of government control is an interesting point, both from the perspective of the ICNPO definition but also from a governance perspective. Tennant et al\textsuperscript{7} discuss the impact of the government contractual model:

As the nature of the relationship between government and the nonprofit sector changes, the term ‘private’ can be ambiguous. While formal ‘institutional separation’ is usually comparatively straightforward, the increasing use of various forms of contractual arrangements between government and sector organisations make the notion of ‘institutional separation’ more porous. Historically, with some important exceptions, the state has been the major provider of health, education, and social services. This has changed in the last two decades with increasing service provision through nonprofit organisations under contract to the state. In some instances new nonprofit organisations have been formed as a direct result of government funding decisions. These changes continue to alter the nature of the government-nonprofit relationship.

The extent of government control through contract and related audit mechanisms has been argued to raise questions about the degree to which some nonprofits are in reality institutionally separate. The experience of many organisations is that while, in theory, they have the option of not accepting contracts with the state, many find that if they do not accept government funding they will not be able to continue their work and thus they accommodate increasing levels of state definition of their work through service contracts. On the other hand, ‘agency theory’...would argue that by virtue of their capacity to control information flows to the state, nonprofits do retain their institutional separateness, and, in theory, their capacity to refuse to enter into contracts that impose onerous obligations upon them, reinforcing their autonomy. The tension for nonprofits

\textsuperscript{7} Margaret Tennant et al. \emph{Defining the Nonprofit Sector. New Zealand} (Working Papers of the Johns Hopkins Comparative Nonprofit Sector Project no 45, The Johns Hopkins Center for Civil Society Studies Baltimore, 2006), 35.
in Aotearoa/New Zealand is that, in many instances, there are limited alternative funding sources if government contracts are not accepted.

This extract summarises the governance dilemma for NFPs – unlike a commercial entity with control over its sources of revenue and the manner of application of that revenue, an NFP typically is heavily reliant on third party funders, either state or philanthropic. (Government grants and contract payments account for 25% of revenue and philanthropy for 20%). With that reliance goes influence in terms of application of funds either through a grant-approval process or through contractually imposed outcomes and reporting criteria. For these reasons practical governance differs significantly for the NFP sector.

D Legal Classification

NFPs do not have to be formally incorporated but some sort of legal registration is usually required to obtain state or philanthropic funding. Consequences in terms of accountability also flow from incorporation; these are considered in more detail below.

Tennant et al summarise the most common NFP vehicles in New Zealand. The most common form of incorporated entity is the incorporated society, registered under the Incorporated Societies Act 1908. Approximately 21,500 incorporated societies were registered as at October 2005, representing 60% of all registered NFPs. Trusts registered under the Charitable Trusts Act 1957 are the second most common form of registered NFP. As at October 2005 15,000 charitable trusts were registered, representing approximately 30% of the sector. Companies can also operate as NFPs but this is not common in New Zealand.

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8 Jackie Sanders et al, The New Zealand Non-profit Sector in Comparative Perspective (Office for the Community and Voluntary Sector, Wellington 2008), 17.
The other legal forms for NFPs are Friendly Societies (registered under the Friendly Societies and Credit Unions Act 1982) and Industrial and Provident Societies (also known as mutuals and cooperatives), incorporated under the Industrial and Provident Societies Act 1908. Neither of these models is now common, and in the case of Industrial and Provident Societies fall outside the structural-operational definition above, in that profits may be paid to members.

The Maori Trust Board Act 1955 provides prescriptive powers, objectives and accountability rules which are inflexible in comparison to the Incorporated Societies Act 1908 and the Charitable Trusts Act 1957. The Law Commission in 2006 proposed a new legal framework for Maori groups, noting in particular the need to facilitate the management of communally owned Maori assets. This legislation has not yet been enacted.

Finally, there is a range of statutory bodies created and governed by their own legislation e.g. the Anglican Trusts Act 1981, the Royal New Zealand Foundation of the Blind Act 2002 and the Te Runanga o Ngai Tahu Act 1996.

This paper focuses on incorporated societies, charitable trusts and charitable companies, as the most common forms of NFP within the health and disability sector.

III THE CONCEPT AND PURPOSE OF GOVERNANCE

A Introduction

“Governance” as a concept has its origins in the corporate sector, focusing on the means by which the objectives of the company are achieved. The Organisation for Economic Cooperation and Development describes both internal and external dimensions of governance\textsuperscript{11} - first, the “structure through which the objectives of the company are set, and the means of attaining those

\textsuperscript{11} OECD Principles of Corporate Governance 2004 www.oecd.org/daf/corporate/principles accessed 2 November 2008,\textsuperscript{11}
objectives, and monitoring performance” and second, the relationship between the board and the company’s shareholders and its other stakeholders.

Farrar\textsuperscript{12} traces the history of corporate governance to the late 19\textsuperscript{th} century. With the development of professional management of companies and the mechanism of issuing shares to raise equity, potentially conflicting interests arose between the company owners (shareholders) and the managers with day to day control. This is described as the agency dilemma - “[m]anagement, in the absence of a countervailing power, have a tendency to pursue their own self–interest at the expense of the corporation.”\textsuperscript{13}

The response to this agency problem was the development of systems of checks and balances to monitor the management of the company and to ensure that the company’s activities were conducted lawfully and that the primary purpose of the company - the maximisation of wealth for shareholders - was achieved.

Corporate governance was initially driven by company law, containing obligations for company directors, financial reporting requirements and protection for shareholders. Industry self regulation added to governance as did the common law, extending the limits of the courts’ involvement in such self regulation.\textsuperscript{14}

\textbf{B \hspace{1em} Contemporary Corporate Governance}

Farrar\textsuperscript{15} describes contemporary corporate governance in terms of concentric rings, with legal regulation at the core of the concept, followed by industry regulation such as financial disclosure requirements; then sector self regulation such as codes of conduct and finally at the outermost level, the application of business ethics.

\textsuperscript{12} John Farrar Corporate Governance (third edition Oxford University Press Victoria, Australia 2008).
\textsuperscript{13} John Farrar Corporate Governance (third edition Oxford University Press Victoria, Australia 2008),12.
\textsuperscript{14} \textit{R v Take-over Panel ex p Datafin plc} [1987] QB 815.
\textsuperscript{15} John Farrar Corporate Governance (third edition Oxford University Press Victoria, Australia, 2008),4.
The role of the law in corporate governance is arguably more fluid than this approach suggests. The development in New Zealand of Financial Information Disclosure Requirements (“FIDR”) is an example of regulation driven (in this case) by the accountancy profession and effectively imposed on companies by being accepted first as best practice, and subsequently being enshrined in law.

FIDRs were developed by the New Zealand accountancy profession initially as guidance statements, then as Statements of Standard Accounting Practice (from 1974), as Financial Reporting Standards (from 1992) and more recently as the New Zealand International Financial Reporting Standards. Until there were legal and professional requirements to comply, the FIDRs were more suggestive of good practice, open to variation in application and were not binding.

In 1993 the Accounting Standards Review Board was established under the Financial Reporting Act, with power to approve Financial Reporting Standards for the purposes of the Act. S11 provided that financial statements of reporting entities must comply with generally accepted accounting practice, being Financial Reporting Standards approved by the Board.16 In this way, industry regulation evolved from best practice to in industry self regulation to formal legal regulation.

Self regulation in governance has also occurred through the development of industry codes, principles and guidelines, all purporting to embody best practice for users. The two most prominent New Zealand codes are the Securities Commission Principles and Guidelines17 and the Institute of Directors The Four Pillars of Effective Board Governance.18 Each of these codes sets out a number of principles with associated guidance as to implementation of the principles. The Securities Commission code expressly provides that the principles can be applied to any entity that has economic impact in New Zealand.

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18 The Institute of Directors (Incorporated) Principles of Best Practice for New Zealand Directors: The Four Pillars of Effective Board Governance (The Institute of Directors (Incorporated), Wellington 2007).
Zealand or which is accountable to the public,\textsuperscript{19} despite the Commission’s primary focus on issuers of securities. Its principles are as follows:\textsuperscript{20}

1. Directors should observe and foster high ethical standards.
2. There should be a balance of independence, skills, knowledge, experience, and perspectives among directors so that the board works effectively.
3. The board should use committees where this would enhance its effectiveness in key areas while retaining board responsibility.
4. The board should demand integrity both in financial reporting and in the timeliness and balance of disclosures on entity affairs.
5. The remuneration of directors and executives should be transparent, fair, and reasonable.
6. The board should regularly verify that the entity has appropriate processes that identify and manage potential and relevant risks.
7. The board should ensure the quality and independence of the external audit process.
8. The board should foster constructive relationships with shareholders that encourage them to engage with the entity.
9. The board should respect the interests of stakeholders within the context of the entity’s ownership type and its fundamental purpose.

The Institute of Directors code is binding on its members. It defines good corporate governance as:\textsuperscript{21}

…the effective separation, management and execution of the relationships, duties, obligations and accountabilities that constitute an entity’s existence such that the entity is best able to fulfil its fundamental purpose. Corporate governance for boards and directors does not exist as an end in itself; it exists for a purpose. This purpose must be to make the entity’s attainment of its fundamental purpose (articulated by the company and subscribed to by its shareowners and other stakeholders) more likely in prospect or greater in deed.

The commentary specifically refers to non-commercial and public sector entities, noting that their purpose will be to ensure “the viability of the organisation as a base from which policy, non-profit, public good or commercial objectives can be pursued.”\textsuperscript{22}

\textsuperscript{21} The Institute of Directors (Incorporated) Principles of Best Practice for New Zealand Directors: The Four Pillars of Effective Board Governance (The Institute of Directors, Wellington 2007), 2.
\textsuperscript{22} The Institute of Directors (Incorporated) Principles of Best Practice for New Zealand Directors: The Four Pillars of Effective Board Governance (The Institute of Directors, Wellington 2007), 3.
The IOD’s Code of Practice for Directors\textsuperscript{23} sets out the following principles:

1. Observe and foster high ethical standards:
2. Act in good faith and generally in the best interests of the company
3. Comply with the spirit and the letter of the law
4. Engage in the development, approval and monitoring of company strategy
5. Recognise and manage risk through identification, monitoring and control
6. Structure the board for a balance of skills, knowledge and experience, to provide effective oversight and add value.
7. Encourage openness, challenge, and independent thinking in board composition and decision-making.
8. Align director and employee remuneration and incentives with company strategy and performance
9. Ensure all shareholders and classes of shareholders are treated fairly according to their different rights
10. Recognise and respect the legitimate interests of stakeholders
11. Foster constructive relationships with shareholders that encourage them to engage with the entity
12. Ensure the quality and independence of the internal and external audit processes.
13. Remunerate directors and management fairly and transparently
14. Recognise the appropriate division between board and management
15. Ensure a balanced agenda of structural conformance and performance matters for board consideration.
16. Monitor and control performance through accurate and timely internal and external reporting.
17. Monitor and regularly evaluate board and management performance
18. Encourage efficiency in board and company operations and in the company’s operating environment.

Each of these codes embodies the OECD dual focus on internal and external processes and relationships with attention to core legal obligations and extends to Farrar’s outermost concentric circle of business ethics. Best practice makes good corporate sense and provides comfort to stakeholders.

Following the analogy of the development of accounting standards, it is interesting to consider whether governance codes should also become part of a regulatory regime. It is likely to be a truism that competent entities with high

\textsuperscript{23} The Institute of Directors (Incorporated) Principles of Best Practice for New Zealand Directors: The Four Pillars of Effective Board Governance (The Institute of Directors, Wellington 2007), 144.
performance (in whatever field) follow many of these principles and that poor performers would benefit from adopting such practices.

Stephen Franks\textsuperscript{24} suggests that codes should remain guides to governance rather than having legally binding effect. He raises the example of a company in financial or other difficulties to illustrate the problem with a rule requiring firm division between management and governance.\textsuperscript{25}

At the core of much of the governance literature is a conviction that directors should stay out of management and operational matters. On that basis their role is setting directions, approving strategies (if they do not have responsibility for developing them) and monitoring performance against pre-set goals...But company law makes directors responsible for the management of the company. There is no escape for directors from legal responsibility, and probably liability, if they allow executives to continue in control with full delegated authority in whom they have reason to doubt competence or probity.

Accordingly, for legal liability reasons if for no other, the board must be prepared to cross the governance/management boundary; and there are other reasons. A board which does not expect its directors, or at least some of them from time to time, to dig deep into management or operational matters, is unlikely to be well enough informed to properly appraise or monitor performance, or even to recognise early enough when things are going wrong.

Only systematic processes allowing for detailed questioning will reduce the risk of a board effectively condoning nonfeasance or even misfeasance through inability to recognise the warning signs.

This argument makes good practical sense, however in the face of recent corporate collapses and the litigation that will inevitably ensue, it is likely that in any examination of the conduct of directors and officers and related consideration of the relevant standard to apply to directors’ conduct, plaintiffs would consider the Securities Commission and Institute of Directors best practice statements on governance.

25 Stephen Franks “Corporate Governance Codes: Rules or Guidelines?” [2002] CSLB 29,30.}
Carver\textsuperscript{26} also adopts the internal and external dimension approach to governance and describes the purpose of governance as being “to ensure, usually on behalf of others, that an organisation achieves what it should achieve while avoiding those behaviors and situations that should be avoided”, commenting that typically governance processes are not designed to do this and fail to do so. His model is more prescriptive than those described above, based on a core role of policy making and monitoring on the part of the board to achieve the following:

- Hold and support vision upfront.
- Ensure board focus on values.
- External focus i.e. on needs and markets rather than on internal issues.
- Establish a mission in terms of outcome and enforce it as the central organising focus.
- Separate large issues from small ones.
- Future thinking.
- Proactive rather than reactive thinking.
- Facilitate diversity of thinking and unity of outcome.
- A self disciplined board.
- Delineate the board’s role on common topics.
- Identify what core information is needed to govern and ensure its accuracy and timeliness.
- Clarify aspects of management that need tight versus loose control.
- Use board time efficiently.
- Be powerful but not stultifying.

Carver’s model is presented in a NFP context, but he notes its application to commercial entities.

The common factors for governance in both the NFP and commercial sectors are the identification and prioritising of the purpose of the entity and the recognition of the ownership of the entity as the origin of board accountability and of the legitimacy of the organisation. Carver describes ownership in moral terms as “those on whose behalf the board has any responsibility to others”\textsuperscript{27} and says that this approach to ownership stops the core group of stakeholders from being lost in a general array of stakeholders. The test for ownership is not with whom the board makes a deal, but whom the board has no moral right not to recognise.

\textsuperscript{26} Carver, John \textit{Boards That Make a Difference} (Jossey-Bas, San Francisco, 2006), xxvii.
\textsuperscript{27} Carver, John \textit{Boards That Make a Difference} (Jossey-Bas, San Francisco, 2006) 186-188.
This approach fits neatly with more recent views on corporate governance. Noonan and Watson\(^{28}\) question the foundations of company law – in whose interests should companies be run, who should run them and who does in fact run them. Directors’ duties to run the company in good faith and in what they believe to be the best interests of the company are traditionally interpreted from the perspective of the shareholders. This can however extend to the interests of future shareholders i.e. a long term interest. In a case where a company is to cease trading, the interests of employees can be taken into account. And in a situation of insolvency, the interests of creditors arise.

Post et al\(^{29}\) explore the same concept and describe the fundamental questions as being – what is the corporation and to whom and for what are it and its managers responsible? The attraction of the company model is its capacity to obtain and hold wealth from a variety of investors and to spread, and therefore limit, financial risk. The primary purpose of the company has always been to create wealth, but the authors note that this wealth cannot be solely for the shareholder. There must be sufficient wealth to provide earnings for investors, compensation for employees and benefits in excess of costs for customers.\(^{30}\) The interests of shareholders in that wealth must in fact rank behind those of the employees and customers, because the amassing of wealth rests on the involvement of each of those groups in the company.

The authors conclude that this type of analysis has led to the stakeholder model of the company. Companies should take account of value derived from different sources; they rely on many different sources of input and should not be able to survive if the wider interests of stakeholders are not taken into account.

The stakeholder view of the company becomes:\(^{31}\)


The corporation is an organization engaged in mobilising resources for productive uses in order to create wealth and other benefits (and not to intentionally destroy wealth, increase risk or cause harm) for its multiple constituents or stakeholders.

Stakeholders on this analysis are those who supply critical resources, place something of value at risk, or who have an ability to affect the organisation’s performance.

In this way both the law and contemporary corporate governance have grown, balancing the interests of a wider group of stakeholders against the protection of the limited liability company and the associated protection of the business judgement rule. As Franks suggests, governance is a balancing exercise and it must allow flexibility to ensure that the entity is adaptable and capable of growth.
IV GOVERNANCE IN THE NFP SECTOR

A Introduction

Governance, as noted above, is primarily concerned with the means by which an entity ensures that it achieves its purpose. For organisations that have wider purposes than maximising shareholder value, wider stakeholders than owners, and that cannot track performance solely by way of share price, or other purely financial means, governance becomes more complex. Cornforth\(^{\text{32}}\) identifies this issue and says that much of the academic comment is prescriptive, “oversimplifying the problems, underestimating the conflicting demands and pressures that board members face, and presenting solutions that are difficult to implement in practice.”

For NFPs, governance focuses on defining the purpose of the NFP, identifying in whose interests the entity operates and identifying how the entity will achieve that purpose. Perhaps just as important for an NFP is the need to determine how its various stakeholders will judge performance and accordingly how it will ensure that those stakeholders are informed of performance.

None of these concepts is new to the contemporary view of corporate governance discussed above, but each of these issues is arguably more complex than it would be for a commercial entity.

The reason for this dilemma, in the writer’s view, is the different – in comparison to commercial entities - sources of revenue of NFPs and the more varied sources of legislative obligations, few of which focus on achievement of the NFP’s fundamental purpose.

Governance in the NFP sector has been sidetracked - and perhaps rightfully so - by stakeholder calls for greater accountability. Increased expectations of the NFP sector and calls for greater accountability and transparency are nothing

new. Gousmett\textsuperscript{33} outlines a history of official investigations into charities in England dating back to the 15\textsuperscript{th} century and 2 Hen V c.1 whereby charitable hospitals were to be reviewed as to “the manner of the foundation, estate, and governance of the same” through to 43 Eliz c 4 “An Act to redress the misemployment of lands, goods and stocks of money heretofore given to charitable uses” and generally the poor governance of charitable trusts.\textsuperscript{34} Charity Commissioners were appointed in the 19\textsuperscript{th} century and the Charities Commission for England and Wales was established in 1993.

In New Zealand, concerns about the accountability of charities were identified in 2001 by the Inland Revenue Department, in response to a call for increased reporting by charities:\textsuperscript{35}

7.1 Because current arrangements contain no obligatory reporting requirements for charities, it is possible for an entity to claim charitable status, and have access to the taxpayer subsidy without the government having knowledge of this, without any monitoring of the entity’s activities or the use of the funds it raises…

7.2 There is no means by which the government can know how much it is spending on the charitable tax exemption, although information is available about the amount of rebates claimed.

... Accountability

7.4 Apart from random Inland Revenue audits and the provisions of the Charitable Trusts Act, there is no process for monitoring whether entities are pursuing the charitable purposes for which they were set up.

7.5 Inland Revenue has a role in monitoring charities to ensure that section CB4 of the Income Tax Act is being complied with. However, regular monitoring would involve extremely pro-active audit activity on the part of Inland Revenue, as no information is available to the department on which it can make a decision to conduct an audit.

7.6 When the government contracts with voluntary organisations or others to provide services in the community, some form of reporting is always required. The level of reporting varies from sector to sector. …generally, the government expects audited accounts to be provided to ensure that public money is being used for the purposes for which it was intended. No such accountability is required for the charitable tax exemption to be accessed.

...It is not always clear whether profits of commercial operations carried on by, or owned by charities are distributed to the charitable purposes for which the entity was established.

It is clear from these comments that funders are not viewed as adequate monitors of charitable operations. The publication refers to the reporting

\textsuperscript{33} Michael Gousmett “Governance of Charities” [2008] NZLJ 106.

\textsuperscript{34} Michael Gousmett “Governance of Charities” [2008] NZLJ 106, 106.

required by government funders, yet this process raises its own governance issues in relation to the independence of the NFP to achieve the purposes recorded in its founding document. Farrar\textsuperscript{36} notes that NFPs fall between private sector ownership constraints and the bureaucratic and political public sector controls. It is not yet clear how the New Zealand Charities Commission intends to address these issues of accountability. The implications of these issues are explored in the remainder of this section.

### B NFP Governance Concepts

Farrar\textsuperscript{37} describes four different cultures of NFP governance; the trust culture (legalistic and appropriate for bodies that actually are trusts, especially charities), the membership culture (with membership control which potentially can lead to mandates incompatible with charity laws), the stakeholder culture (consensus-driven and common in bodies providing services) and the strategic culture (a private sector approach concentrating power in the board and the CEO).

Carver\textsuperscript{38} prescribes a policy model of governance, with the board’s primary role being to develop, implement and monitor policies covering:

1. The outcomes to be achieved by the NFP. This focuses the board on what the organisation is for rather than what it does.
2. The means by which the outcomes will be achieved. This is the role of management provided the board has processes to ensure that staff operations are prudent and effective.
3. The board-management interface.
4. The practice of governance- that is, the “manner in which the board represents the ownership, disciplines its own activities and carries out its own work of leadership.”\textsuperscript{39}

\textsuperscript{36} John Farrar Corporate Governance (third edition Oxford University Press Victoria, Australia, 2008) 442.
\textsuperscript{37} John Farrar Corporate Governance (third edition Oxford University Press Victoria, Australia, 2008) 443.
\textsuperscript{38} Carver, John Boards That Make a Difference (Jossey-Bas, San Francisco 2006), 48-51.
\textsuperscript{39} Carver, John Boards That Make a Difference (Jossey-Bas, San Francisco 2006), 52.
These two approaches to the theory or concept of governance differ, in that Carver’s describes an ideal or model, which in his view is adaptable for any NFP. Farrar’s description is of governance as it has been observed in the NFP sector, with the particular manifestations and problems of each of the cultures.

In the health and disability sector a further evolution of governance culture exists, driven by the sources of funding and in particular by the contractual requirements imposed on NFPs which are service providers. This model has been called a "hybrid" by a number of commentators. Barnett et al⁴⁰ discuss health governance in relation to District Health Boards, where statutory board committees undertake specified⁴¹ areas of governance:⁴²

The emerging literature on health governance points to ‘hybrid’ type models that increasingly do not conform to strict corporate, philanthropic or other governance traditions but are created specifically for the context in which they operate and are ‘fit-for-purpose’. The DHB model fits this arrangement, with our informants confirming that the design aimed to achieve specific goals or representation, while maintaining the role of central policy. The specific elements of the structure, designed to create transparency, community engagement and a specific ‘issues focus’ through the Committees, do not appear to make a major contribution to decision making, although they do not undermine it in any way and create a positive community profile. This is consistent with literature that concludes that structures have little impact on decision making.

This form of governance hybrid is statute-imposed governance, with the underlying purpose consistent with:⁴³

[I]he prime purpose of governance…to support the aims of the organisation and its accountabilities. In the case of health governance, especially in the public and non-profit sector, approaches emphasise the different dimensions of the roles and responsibilities of the board, different relationships between wider stakeholders (government and the community), board members and staff.

⁴² Barnett, Pauline and Clayden, Clare Governance in District Health Boards (Health Services Research Centre Victoria University of Wellington, N.Z 2007), xvi.
⁴³ Barnett, Pauline and Clayden, Clare Governance in District Health Boards (Health Services Research Centre Victoria University of Wellington, N.Z 2007) 6.
Barnett et al conclude that the traditional approaches to NFP governance, outlined by Farrar above, have become inadequate because the interlocking nature of the health (and disability) sector means that systems of governance focusing on an individual entity are neither relevant nor helpful. “…health governance [is] represented by ‘hybrid’ configurations with a mix of corporate and philanthropic attributes, and a pragmatic approach to decisions on structures.”44

Low45 takes the concept of the hybrid governance model further, noting that many NFPs providing social services conduct both non-profit and for profit activities (for example renting out part of the entity’s premises and using the rent to support the NFP activities). This in turn suggests that the hybrid will be a combination of the for-profit stewardship model of governance and the non-profit democratic model.46 This is a natural consequence of the desire on the part of NFPs to achieve independence from reliance on government funding and control. This typically leads to consideration of how the entity can attract other forms of funding, which in turn leads the board to seek “commercial” skills such as business development, and strategic planning rather than focusing primarily on service provision. In turn, this representation of commercial skills tends to steer boards to adopt more commercial approaches to governance.47

The value of the hybrid model of governance is that it facilitates a greater level of professionalism within the entity, particularly in relation to long term planning for the entity, while enabling the NFP to maintain its focus on its fundamental purposes. The danger is that the more “commercial” the entity is regarded as by the wider group of stakeholders, the greater the likelihood that it will be perceived to be moving away from its history and purpose and with that comes the risk of losing its voluntary supporters, both workers and donors.

44 Barnett, Pauline and Clayden, Clare Governance in District Health Boards (Health Services Research Centre, Victoria University of Wellington, Wellington, N.Z, 2007), 6
Minow\textsuperscript{48} explores the shifting nature of the sector in the United States noting that society will always be reliant on NFPs because neither the state nor the private sector will ever be able to “fully meet the needs of children, poor people, persons with disabilities, substance abusers, and prisoners...The exuberant win/win enterprises joining for-profits and non-profits and the inventive efforts of non-profits to make profits will expand.”\textsuperscript{49} She expresses her concerns about the ability of NFPs to maintain their autonomy and mission in this convergence of state, commercial and NFP objectives and concludes that there is a need for ambitious reform enabling government oversight, but reducing administrative burdens and ensuring adherence to mission:\textsuperscript{50}

The new metaphor must acknowledge how public encouragement and support of private alternatives encompass both for-profit and non-profit, including religious, while at the same time enabling these observers to attend to the very different motives and interests in each of these domains. ... 

The genius in these dimensions of pluralism generates creativity, tolerance, and variety. Making everything public or everything private, everything non-profit or everything for-profit, everything secular or everything religious would undermine each of these values and impoverish each of our lives. Yet sustaining plural sectors and activities requires delicate balancing of competing norms and methods and rigorous internal methods of accountability for each.

The delicate balance Minow refers to is an accurate description of NFP governance. The next section of this paper considers some of the influences on that balance.

\textbf{C \hspace{1em} Influences and Context}

A historical analysis explains the role that NFPs play in the delivery of health and disability services, but does not entirely explain why this role continues. Hansmann\textsuperscript{51} suggests that consumers have a preference for dealing with NFPs.\textsuperscript{52}

\begin{flushleft}
\textsuperscript{48} Martha Minow “Partners, Not Rivals?: Redrawing The Lines Between Public and Private, Non-Profit And Profit, And Secular and Religious” (2000) 80 Boston University Law Review 1061.
\textsuperscript{49} Martha Minow “Partners, Not Rivals?: Redrawing The Lines Between Public and Private, Non-Profit And Profit, And Secular and Religious” (2000) 80 Boston University Law Review 1092.
\textsuperscript{50} Martha Minow “Partners, Not Rivals?: Redrawing The Lines Between Public and Private, Non-Profit And Profit, And Secular and Religious” (2000) 80 Boston University Law Review 1094.
\textsuperscript{52} Henry B Hansmann “The Role of Nonprofit Enterprise” (1980) 89 Yale Law Journal 896.
\end{flushleft}
...based upon a feeling that non-profits can be trusted not to exploit the advantage over the consumer resulting from the contract failure. This trust derives its rational basis from the nondistribution constraint that characterizes the nonprofit form.

(“Contract failure” is the inability to police producers by ordinary contractual devices such as the ability to accurately compare price and product prior to purchase, negotiate key terms of the contract and to assess compliance and seek redress). 53

He views the constitution or other founding document of the entity as the basis of protection for consumers from those who control the organisation – arguably this could be applied to the wider group of stakeholders including funders, trustees or others seeking to amend the direction of the entity or indeed other consumers lobbying for change: 54

It follows from these basic notions that the corporate charter serves a rather different function in nonprofit organizations than it does in for-profit organizations. In the case of the business corporation, the charter, and the case law that has grown up around it, protect the interests of the corporation’s shareholders from interference by those parties—generally corporate management and other shareholders—who exercise direct control over the organization. In the case of the non-profit corporation, on the other hand, the purpose of the charter is primarily to protect the interests of the organization’s patrons from those who control the corporation. For this fundamental reason, the corporate law that has been developed for business corporations, and particularly that which concerns the fiduciary obligations of corporate management, often provides a poor model for nonprofit corporation law.

Any governance regime must allow flexibility to enable adaptation to changing political, economic and social circumstances. This has been the subject of ongoing debate in common law jurisdictions in relation to the limitations of charity law. The issue here is whether the Statute of Charitable Uses 1601 classification of “charitable purpose” (as further refined in Commissioners for Special Purposes of Income Tax v Pemsel [1891] AC 531) is unduly restrictive and fetters rather than facilitates the potential role of charities. Dunn55

describes the evolution of charities in England from Tudor times to the contemporary NFP sector. She notes how a sector once relatively unregulated and at the forefront of advocacy for social change is now attempting to continue the twin purposes of service and pressure, but in the context of a conflicting policy agenda and a more interventionist regulatory framework. This is further complicated by the desire on the part of the state to use NFPs as a means or conduit through which to engage with consumers and other stakeholders.56

As noted above, one of the major changes for the New Zealand health and disability sector occurred in the 1990s with the move to a contractual model of engagement between (state) funder and provider. The contract was the mechanism by which the efficient quasi market was to be achieved through the imposition of both private sector disciplines and private law on the relationship between funders and providers:57

As well as promoting efficiency, contract was said to offer the possibility of greater transparency and participation by citizens in service specification and provisions and in the goals of public spending. Such processes could consequentially provide safeguards against bureaucratic captures. The contractual paradigm has been used as a metaphor for a new form of governance whereby government and NFP negotiate over policy and its implementation.

McLean notes58 59 that the contractual paradigm did not achieve these expectations. It endured in any event, due in McLean’s view to the fact that contracts were used to manage relationships rather than enforcing compliance, and as a technique for specifying outputs and quantifying costs.60

But the contractual approach has had ongoing implications for governance of NFPs. Low considers the effect of external pressures on NFPs:61

[The democratic model of governance] relies on a perspective that assumes that the external environment is a powerful force acting upon the organisation, and that those outside of the organisation confer a form of approval on the actions of the organisation.

59 See also Jane Bawden Issues Arising From The Devolution Of Responsibility And Funding For Health And Disability Services In New Zealand (A dissertation submitted in partial fulfilment of the requirements of the degree of LLM, The University of Auckland, 2008).
This contrasts with the stewardship model as it opens up the prospect that the organisations can be judged not only from above (by shareholders) but also from below by stakeholders at large.

Implicit to the democratic model is the notion that individual expertise in governance is secondary to a claim to be a representative of a particular stakeholder group. Although this suggests that governance expertise is mutually exclusive to representative status - a telling observation about theorists' beliefs about stakeholder capabilities - more importantly it highlights the tension between theories of corporate and non-profit governance. Corporate governance believes in board members qualifying purely on the basis of expertise in managing and accumulating assets. In contrast, non-profit governance is built on the notion that those managing an organisation at the highest level should be on the board because of who they represent rather than their ability to manage the assets of the organisation. It follows therefore that the performance of a non-profit will be judged in part on the basis of who is on their board rather than what they achieve whilst in that role.

And herein lies the tension for NFPs in this sector - their context demands responsiveness and engagement with funders and policy makers and also with their ownership base to use Carver’s concept of ownership⁶² i.e. members and consumers or potential consumers. The contractual model for state funded entities is in reality one of control - outputs are specified, organisational processes may be prescribed in detail and the role for the governors of the entity may be limited. Governance becomes a balance between maintaining relationships with external funders and a level of autonomy around how the mission of the NFP is achieved.

Cornforth⁶³ emphasises the importance of context when looking at governance in the NFP sector. He summarises what he terms the “paradoxes of governance” as first, the tension between effectiveness and accountability in terms of who is on the board - professionals or representatives. Secondly, the tension between performance and conformance - conformance requires attention to detail, exercise of care, skills in monitoring, evaluation and

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reporting. A performance role requires forward vision and risk taking. And thirdly, the tension between controlling and partnering management and the need for the board to be flexible in determining what form of relationship is appropriate at a given time.\textsuperscript{64}

Cornforth describes this as a dynamic balance whereby boards facing increasing accountability and performance expectations need to become more reflexive giving a high priority to their own maintenance and development and with awareness of their multiple and sometimes conflicting roles.\textsuperscript{65}

\section*{D NFP Governance Codes}

Given the complexity of the governance challenges for NFPs described above, it is perhaps unsurprising that more attention has been given to adapting corporate codes of governance for the needs of NFPs rather than developing specific codes for NFPs. As noted above, in New Zealand the Securities Commission \textit{Principles and Guidelines}\textsuperscript{66} and the Institute of Directors \textit{The Four Pillars of Effective Board Governance}\textsuperscript{67} both express themselves as being applicable to the NFP sector. In the United States in February 2007 the Inland Revenue Service issued \textit{Good Governance Practices for 501 (c)(3) Organizations} for charities, calling on them to voluntarily implement governance best practice. The recommendations are based on actual and potential abuses uncovered by the IRS in audits, exemption applications and compliance checks:\textsuperscript{68}

1. Board composition should address issues of stakeholder representation, effectiveness and professional skills.

2. Charities should clearly articulate their mission communicating why the organisation exists, its objectives, whom it is intended to benefit

\textsuperscript{64} Cornforth, Chris (ed) \textit{The Governance of Public and Non-Profit Organisations} (Routledge, London, 2003), 245-249.


\textsuperscript{66} \textit{Corporate Governance in New Zealand Principles and Guidelines} (2004) \textit{www.sec.govt.nz}.

\textsuperscript{67} The Institute of Directors (Incorporated) \textit{Principles of Best Practice for New Zealand Directors: The Four Pillars of Effective Board Governance} (The Institute of Directors (Incorporated), Wellington 2007).

and how it will effect its mission. Understanding the mission is essential to the fulfilment of fiduciary duties.

3. Charities should develop and monitor a code of ethics and a whistle blower policy. This is seen as fostering a culture of compliance and awareness of fiduciary and legal obligations.

4. As part of the directors’ and officers’ duty of care, they should ensure a reasonable understanding of all significant transactions including the economic and mission implications of the transaction.

5. Charities should develop and monitor a conflicts of interest policy and register, requiring the board and staff to put the interests of the charity ahead of personal interests.

6. Charities should promote transparency by making full and accurate information about its mission, activities and finances publicly available.

7. Charities should develop and monitor policies to ensure that fundraising is conducted in accordance with legal requirements.

8. Charities of all sizes should conduct some level of financial review, with larger charities engaging external auditors.

9. Boards should monitor terms of engagement with employees and professional advisers, especially rates of pay. Directorships should be voluntary.

10. Charities should develop and monitor policies for retention of information and record keeping in general.

England has a more extensive history of codes of governance for NFPs. In 1998 the Home Office developed the Compact Code of Good Practice on Community Groups which focused on mutual expectations between government and NFPs. In 2005 the Good Governance Code for the Voluntary and Community Sector69 was issued. The development of the Code followed similar initiatives by the public and private sectors in England. Its purpose is to enhance effective governance by:70

- Clarifying what effective governance looks like and how governing bodies can govern effectively.

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• Reassuring an organisation’s stakeholders about the way organisations are governed; and

• Maintaining and enhancing public confidence in organisations and in the voluntary and community sector.

It focuses on board leadership, control, performance, review and renewal, delegation, integrity and openness, accountability and transparency. The Code’s format is similar to that of the two New Zealand codes - a set of principles with explanatory support. In contrast though it contains a significant level of detail, which is quite prescriptive.

In addition to the Code, the Charities Commission for England and Wales has recently (July 2008) published CC10- The Hallmarks of an Effective Charity. The foreword to the publication describes itself as a “straightforward framework of good practice which includes the relevant regulatory requirements.” It identifies six principles of good governance and supports these with a description of how they might be manifested in practice. The charity:

1. is clear about its mission, purposes and values;

2. has a strong board with the right balance of skills and experience, that understands its responsibilities and acts in the charity’s best interests;

3. has the structure, policies and procedures to enable it to achieve its mission and purposes and deliver services efficiently;

4. has a continual learning and improvement culture;

5. has adequate resources to achieve its purposes and systems to ensure that the resources are properly controlled and used; and

6. has transparent accountability processes for its stakeholders.

This document is significantly more user-friendly than the Code and is more likely to achieve a workable halfway house between aspirational guidelines and a detailed template presenting a significant workload for NFPs.

Dawson and Dunn argue that governance or “soft law” has developed because companies legislation and contract law were inadequate in that they were too complex, too slow to adapt to change and litigation was too slow and expensive.\textsuperscript{72} They suggest that codes fulfil a social need. “By signing up to a code a party advertises how it will act, which gives a benchmark against which stakeholders may judge its governance enabling publicity to be given, as appropriate, to successes and failures.”\textsuperscript{73}

The authors analyse in detail the shortcomings of the Code, stating that it fails to comprehensively deal with the NFP sector’s special issues (despite being 42 pages in length). These issues are summarised as first, the accommodation of the different visions and organisational structures of the sector, secondly the identification of the stakeholders to which the code would be directed and thirdly, the purpose of the code and enforcement mechanisms.\textsuperscript{74}

These comments in the writer’s opinion highlight the fact that there is not a smooth spectrum from voluntary governance at one end and enforceable law at the other. Expectations of governance codes may over time become accepted as the reasonable standard of care on the part of directors, officers or trustees and, if tested in litigation, become part of the common law in this area. But in the interim governance in general and codes in particular are voluntary and of mixed value to organisations depending on the level of resource an individual entity has to consider and implement governance initiatives.

\section*{E Convergence/Divergence}

Inevitably, given the interest in convergence in corporate governance in the international sphere, thought has also been directed to convergence and divergence between for-profit and NFP approaches to governance. Comment effectively falls into two camps; those who consider that the wider stakeholder model differentiates NFPs fundamentally from for-profit entities and those who

\textsuperscript{72} Ian Dawson and Alison Dunn “Governance Codes of Practice in the Not-For-Profit Sector” (2006) 14 Corporate Governance 33, 35.
\textsuperscript{73} Ian Dawson and Alison Dunn “Governance Codes of Practice in the Not-For-Profit Sector” (2006) 14 Corporate Governance 33, 35.
\textsuperscript{74} Ian Dawson and Alison Dunn “Governance Codes of Practice in the Not-For-Profit Sector” (2006) 14 Corporate Governance 33, 37.
consider that competitive and funding pressures are pushing NFPs into a commercial model with little to differentiate them from commercial entities from a governance perspective.

Steane\textsuperscript{75} is in the former camp. He finds the following characteristics particular to NFPs:\textsuperscript{76}

- Boards include representation of membership and therefore are diverse. Diversity allows greater involvement of board members and a broader base of skills.

- Value is given to length of service in the NFP sector. Research in the USA and UK indicated that more than 50\% of directors are chosen on the basis of demonstrated experience in sector.  

- Governance power is legitimately derived from the NFP’s membership.

- NFPs demonstrate a stakeholder approach to governance, seeking alignment with various interests of community stakeholders. In comparison the shareholder approach to corporate control focuses on efficiency and wealth maximisation.

- The values of NFPs focus on unity and coalescing efforts aligned with vision or ideology. This may incorporate or subsume other concerns of efficiency or profit.

Steane concludes:\textsuperscript{77}

The disadvantages for non-profits coerced into adopting practices aligned to the market environment is that, first, there are financial and political limits to non-profits which are not adept at raising capital and assiduously assessing the political risk of capital flows during the course of a year. A second disadvantage is that non-profits generally possess cultures that idealise the mission or ideological base, to the detriment of pragmatism expected in the marketplace.

Steane and Christie\textsuperscript{78} expand these points noting that\textsuperscript{79}:

When nonprofits are forced to tender in adversarial climates to comply with legislative reforms, they are forced to make decisions and act outside the value-frame that characterises them.

...an overemphasis on instrumental values deprives nonprofits of the strategic positioning value of differentiation which is built upon trust and legitimacy.

\textsuperscript{75}Peter Steane “Governance: Convergent Expectations, Divergent Practices” (2001) 1,3 Corporate Governance 15.
\textsuperscript{76}Peter Steane “Governance: Convergent Expectations, Divergent Practices” (2001) 1,3 Corporate Governance 15-17.
\textsuperscript{77}Peter Steane “Governance: Convergent Expectations, Divergent Practices” (2001) 1,3 Corporate Governance 15, 17.
\textsuperscript{78}Peter D Steane and Michael Christie “Nonprofit Boards In Australia: A Distinctive Governance Approach” (2001) 9 Corporate Governance 48.
\textsuperscript{79}Peter D Steane and Michael Christie “Nonprofit Boards In Australia: A Distinctive Governance Approach” (2001) 9 Corporate Governance 48, 51.
Considine’s\textsuperscript{80} view is that of the second camp, i.e. that in a competitive market
the distinctive role of the NFP will be eroded over time through pressure to
adopt financial strategies and service delivery methods of competitors. In the
health and disability sector with a monopsony purchaser (the state), this trend is
exacerbated. He concludes that NFP diversity will only be maintained in the
short term.

Maya Leatherwood and Don O’Neal\textsuperscript{81} also researched differences between
NFPs and for-profit entities. They found the following areas of convergence and
divergence in the functioning of the board:

- **Board selection:** both for-profit and NFP entities rely on board
  networks more than formal sources to identify new officers/trustees.
  The for-profit CEO tends to have a bigger role than NFP in selection.
  Both also base selection on who is likely to enhance performance and
  relationships with stakeholders. For-profit boards value business
  success, NFP boards value diversity. This mirrors the perception of the
  stakeholder groups that are the most important.

- **Feedback** for both types of board tends to be informal rather than
  formal.

- **Roles and responsibilities** differed: for-profit boards prioritised control
  over service and strategy. NFP boards prioritised service and then
  strategy and control.

- For-profit boards identified their primary responsibility as being to their
  shareholders/owners. NFP boards see their primary responsibility as
  being to clients/users or the community, or to donors.

- NFP boards were more likely to have term limits than for profit boards.

Steane and Christie\textsuperscript{82} studied Australian NFPs with similar conclusions. In
addition the NFPs in their study overwhelmingly (82%) considered that the
welfare of the recipients of their services was the mission of the entity. The
authors comment:\textsuperscript{83}

\textsuperscript{80} Mark Considine “Governance and Competition: The Role of Non-Profit Organisations in the Delivery of Public Services” (2003) 38 Australian
Journal of Political Science 63.

\textsuperscript{81} Marya Leatherwood and Don O’Neal “The Transformation of Boards in Corporate and Not-For-Profit Sectors: Diminishing Differences and
Converging Contexts” (1996) 4 Corporate Governance 180.

\textsuperscript{82} Peter D Steane and Michael Christie “Nonprofit Boards In Australia: A Distinctive Governance Approach” (2001) 9 Corporate Governance 48.

\textsuperscript{83}Peter D Steane and Michael Christie “Nonprofit Boards In Australia: A Distinctive Governance Approach” (2001) 9 Corporate Governance 48, 54.
In this way, nonprofit organisations diverge from the prevailing economic logic by building support based upon trust and reputation. The survival and continued growth of nonprofit service reinforces the value of intangible phenomena, such as trust and legitimacy as a core asset.

Barnett et al\cite{84} also sit in the second camp. Their view (admittedly in the quasi commercial environment of public health providers in the 1990s) is that the voluntary/philanthropic model of governance is not sufficiently flexible to operate in an environment of increased accountability and business performance. The corporate models is seen as more adaptable and flexible and more accountable through agency relationships and greater focus on business and service goals.

\section*{Conclusion}

One problem with theorising about governance generally and NFP governance in particular, is the risk of becoming side tracked by specific, measurable, aspects of governance, and these are of course the aspects most likely to be researched. The defining features of NFPs – stakeholder mentality and focus on expressive values - are the basis of the trust with which they are viewed by consumers and it is of great importance that this aspect of their character is not lost as a result of policy and/or market pressures. O'Regan and Oster\cite{85} published research in 2005 using data from 1000 NFPs in New York. The research overwhelmingly found that board members serve because they believe in the mission of the entity and that they can assist its achievement. The authors concluded that some of the structural suggestions to improve corporate governance in the Sarbanes Oxley Act 2002 have long been features of NFP boards e.g. board member independence, chair independence and board term limits. In addition the more diverse membership of NFP boards makes them potentially more contentious with more robust debate at board level.

\cite{85} Katherine O'Regan and Sharon Oster "Does The Structure and Composition of the Board Matter? The Case of Nonprofit Organizations" (2005) 21 J L Econ & Org 205.
The challenge for NFP governance is to harness the intrinsic characteristics of the sector and at the same time to satisfy calls for accountability. Jo Cribb recently published the results of her research on accountability in the NFP sector in New Zealand in *Being Accountable: Voluntary Organisations, Government Agencies and Contracted Social Services in New Zealand.* She argues that the contractual model of accountability with control over outputs and sanctions for non-compliance is counterproductive and that in fact a more relaxed form of accountability is needed in this sector. Roderick Deane in his review of Cribb’s publication commented that:

This seemingly more relaxed form of accountability is typical of the relationships many of these organisations have with their clients, which involve care and understanding of and responsiveness to complex and changing client needs and is not easily encompassed in a formal contract. It is based on trust.

Despite the complication faced by many clients of voluntary organisations, and the pressing demands of their immediate caregivers, the research found conclusively and with startling clarity that the relationship with Government was ‘the most difficult and obstructive’ of all the accountability relationships and was very much a ‘hindrance rather than an aid’. Even more worrying, contracting and funding arrangements with government agencies were seen to be ‘driving down standards of care’. This was attributed to poorly designed programmes, irrelevant measures, and a piecemeal approach to service provision.

Deane concludes that the increasingly bureaucratic and centralised control of the sector (and society in general) must be addressed in order to achieve improved standards of service for disadvantaged people cared for by voluntary agencies.

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87 Dr Roderick Deane “Charities and Government” [2007] NZLJ 60.
ACCOUNTABILITY OF NFPs AND REDRESS FOR STAKEHOLDERS

A Introduction

There is an interesting lacuna in the literature on NFP governance. Attention is of course focused on the fundamental purpose of governance - the achievement of the entity’s mission. But little thought has been addressed, within the concept of governance, to the situation where the entity fails to achieve its purpose, or does so in a manner inconsistent with its mission, or changes its mission for reasons stakeholders do not support. This section explores these concepts and in particular the role of the legal system in supporting the intended outcomes of NFP governance.

B Accountability and Redress

The concepts of accountability and redress are inextricably linked. A useful summary describes the core of accountability as:89

…external scrutiny, justification, sanctions and control…in other words the capacity to hold another to account for actions (or inaction) undertaken. Sanctions are crucial to this. The capacity to hold another to account in turn depends upon the transparency of the actions in question...

These concepts have however received little attention in generic codes of governance, other than by way of reminders to comply with legal obligations. Returning to Farrar’s concentric rings of governance, the law is at the core of governance, the starting point for consideration of governance, followed by self regulation (for example the rules of a particular profession), codes of conduct and statements of best practice, and finally by ethical considerations.90

These ideas are easier to conceptualise within corporate governance. The Companies Act 1993 and its predecessors set out a clear framework of

obligations for directors and rights of shareholders and related protection, supported by over 100 years of case law. Specific sections of the commercial sector have their own additional rules such as the New Zealand Stock Exchange Rules.

The NFP sector on the other hand is a mix of different types of legal entity with correspondingly different obligations, comparatively little case law and little effective regulation. The advent of the Charities Commission adds another set of requirements and a central monitoring regime, but its effectiveness is yet to be tested.

Thus the law has a two-part relationship with governance; directing entities as to the basics of governance and protecting stakeholders in the event of governance failures. The remainder of this section of this paper explores the specific legal obligations imposed on the most common forms of NFP in New Zealand.

C Legal Framework

The first role of the law is to provide a framework for the organisation. NFPs do not have to be incorporated but this is desirable for the purposes of limiting personal liability and also because it is a de facto requirement to receive funding and grants.

Miles Agmen-Smith and Mark von Dadelszen refer to two distinct classes of NFPs; first, membership organisations with an executive or board. These tend to operate on democratic principles and have a governing body which is accountable to the members. Secondly, trusts with trustees or a trust board. The trustees are not accountable to any membership, although they are bound

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by the law relating to trustee obligations and to apply trust funds to the purposes of the trust.94

An integral part of the framework for any NFP is satisfaction of the requisite legal definition(s). This is essential to obtain the tax exemptions or “charitable purpose” branding that are the primary motivations for operating within a NFP model.

1. Definitions

There is no single definition of “non-profit” or “charitable purpose”. The Goods and Services Tax Act 1985 defines “non-profit body” as.95

any society, association, or organisation, whether incorporated or not,—

(a)Which is carried on other than for the purposes of profit or gain to any proprietor, member, or shareholder; and

(b)Which is, by the terms of its [constitution], rules, or other document constituting or governing the activities of that society, association, or organisation, prohibited from making any distribution whether by way of money, property, or otherwise howsoever, to any such proprietor, member, or shareholder.

The definition does not distinguish between charities and other forms of NFP.

The Income Tax Act 1994 (section OB 1) adopts the common law “four heads” of charity and defines “charitable purpose” as including:

every charitable purpose, whether it relates to the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community.

The Incorporated Societies Act 1908 requires all societies registered under the Act to be non-profit making (section 20).

The Charitable Trusts Act 1957 (section 2) defines “charitable purpose” as “every purpose which in accordance with the law of New Zealand is charitable…”

The Charities Act 2005 defines “charitable purpose” to include “every charitable purpose, whether it relates to the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community” (section 5). It expressly provides that the inclusion of members

or beneficiaries on the basis of blood relationships does not exclude that entity from the definition of charitable purpose. This clarification was an attempt to ensure that Maori NFPs were not excluded from the Act. A second concern, whether or not advocacy or other non-charitable activities would take an entity outside the definition, is addressed in section 5 (3) and (4). Provided the non-charitable activity is ancillary to the charitable purpose, the entity is not prevented from qualifying as a charitable entity.

2. Incorporated Entities

As noted above, most NFPs are registered under the Incorporated Societies Act 1908 ("ISA") or the Charitable Trusts Act 1957. It is also possible to use a limited liability company incorporated under the Companies Act 1993 as a charitable vehicle. Each of these entities is considered in turn.

(a) Incorporated Society

Section 6 ISA requires the rules of a society to include the name and objects of the society, the manner in which persons can become and cease to be members of the society, the procedure for amending the society’s rules, the procedure for holding and voting at general meetings, appointment of officers, use of the common seal, control and investment of funds, powers (if any) to borrow money, and the disposition of the society’s property in the event of liquidation.

The effect of incorporation under the ISA is that the society becomes a body corporate capable of all the functions of a body corporate, and of holding land and having perpetual succession.96 It also provides protection from personal liability for members in relation to any obligation incurred by the society. 97

It is unlawful for a society to act outside the scope of its objects,98 and specifically to operate for pecuniary gain.99 Any member who “aids, abets,
procures, assists or takes part” in such operations becomes personally liable to any creditor to whom the society is indebted as a result of that operation, and the society can recover any pecuniary gain derived by a member in the name of the society. 100

Societies must provide annual financial statements to the Registrar of Incorporated Societies. 101

The society, or a member, or creditor or the Registrar can apply to the High Court for the appointment of a liquidator. 102

Any person is entitled to inspect documents lodged with the Registrar (this presumably includes the annual financial return) and the Registrar has wide powers of inspection of a society’s documents under section 34A ISA.

(b) Charitable trust incorporated under the Charitable Trusts Act 1957 (“CTA”).

The CTA provides for the incorporation of two types of trust entities, first a society (under s8 CTA) and secondly a trust board under s7 CTA (confusingly, both are referred to as trust boards). An application for incorporation under the CTA must provide evidence of the general purposes of the trustees or society making the application and the trusts on which any property is held. 104

A trust board is registered once the Registrar is satisfied that the purposes of the trust or society are exclusively or principally charitable and has issued a certificate of incorporation. 105 From the date of incorporation the trust board is a body corporate consisting of the trustees of the trust or the members of the society. 106 The trust board then has all the powers of a body corporate,
perpetual succession, the power to hold any property and of suing and being sued.\textsuperscript{107}

Section 24 CTA provides for voluntary liquidation of a society incorporated as a trust board. S25 CTA provides for liquidation on “just and equitable grounds” on application by the Attorney-General, or the Board or any member, or a creditor, the Registrar or “any other person, who in the opinion of the Court, should make the application”. The Registrar has the power to dissolve a Board that is no longer carrying on its operations or that has been registered by a mistake of fact or law.\textsuperscript{108}

Any person is entitled to inspect any document held by the Registrar (s29 CTA).

Express powers of investigation into the condition and management of all charities (i.e. not only registered trust boards) is provided for under s58 CTA.

(c) Companies

A company incorporated under the Companies Act 1993 will be accepted as charitable for the purposes of the Income Tax Act 1994 if its constitution restricts its shareholders to charitable entities, or only permits distributions to charitable entities.\textsuperscript{109} The company model may be preferred for two principal reasons, first for the governance regime the Companies Act provides and second to enable capital investment through shareholding. It also provides for a simple process of share transfer between members.\textsuperscript{110} The primary disadvantage of a charitable company is the loss of the charity “brand” more commonly associated with charitable trusts and societies.

\textbf{D Duties}

The summary of relevant law above illustrates the paucity of express statutory obligations for trustees and officers in comparison to the scheme of the

\textsuperscript{107} S 13 Charitable Trusts Act 1957.
\textsuperscript{108} S 26 Charitable Trusts Act 1957.
\textsuperscript{109} Miles Agmen-Smith and Mark von Dadelszen “Advising Not-for-Profit Organisations” (New Zealand Law Society, Family Law Section, Property Law Section, [and] Continuing Legal Education Wellington, NZ 2005), 20.
\textsuperscript{110} Miles Agmen-Smith and Mark von Dadelszen “Advising Not-for-Profit Organisations” (New Zealand Law Society, Family Law Section, Property Law Section, [and] Continuing Legal Education Wellington, NZ 2005), 20.
Companies Act 1993. The duties of officers of charities at common law and equity are summarised in Law of Trusts, LexisNexis (paragraph 4.51) as being to:

- know the founding document;
- know the charity’s assets and liabilities;
- advance the charity’s purposes;
- comply with fiduciary duties of honesty, loyalty and acting in the best interests of the charity;
- exercise reasonable care, skill and diligence;
- act impartially amongst beneficiaries;
- sell wasting property;
- insure assets and keep property safe and in repair;
- keep inventories
- invest within a reasonable time and prudently
- not delegate;
- act jointly where there is more than one officer;
- act gratuitously and to not profit by charity property;
- be accountable; and
- be honest, loyal, diligent and prudent in carrying out the terms of the charity.

But summarising these duties is one thing, establishing a breach is another. AS Sievers in “The Honorary Director: The Obligations of Directors and Committee Members of Non-Profit Companies and Associations” outlines a particular difficulty in establishing the relevant standard of care:

It is clear that the committee members of an association, whether or not it is incorporated, have a duty to act honestly. The difficulties start when it is not a question of honesty or bona fides but a question of care, skill or diligence. What standard of care should be required from an unpaid voluntary committee member who has no business or professional training or experience? It has always been extremely difficult to prove that directors of commercial profit-making companies have breached their duty of care, skill or

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diligence. Enforcement is likely to be even more difficult in the context of non-profit associations or companies.

The position of trustees of charitable trusts may in fact be more exposed (or provide greater accountability depending on from whose perspective one considers the issue) in that trustees are not protected by the business judgment rule that provides some level of protection to directors of commercial entities. Trust law also provides clear restrictions on trustees in terms of dealing with trust property. Again though, any disgruntled stakeholder must satisfy tests of standing and fund any proceedings.

**E Failures and Redress**

There is surprisingly little case law in relation to the ISA and CTA, or the exemption provisions of the Income Tax Act, lending support to the concerns of the Inland Revenue Department as to a lack of accountability and monitoring on the part of NFPs in general and charities in particular.¹¹³

The lack of clear statutory definition of the duties of officers and trustees may compound the problem, as would the cost of commencing proceedings for an individual stakeholder, assuming that standing was satisfied. It is an open issue as to what extent the rules, constitution or other founding document of a NFP confer private law rights on third parties.

There are a number of well known cases with repercussions for the NFP and or its officers or trustees:

1. **Charitable purpose**

*MK Hunt v CIR* [1961] NZLR 405 is an example of the risk that a charitable entity runs in carrying on commercial activities. In this case the company sought tax exemptions on the basis that its memorandum of association restricted distributions to a named charitable trust and that it too was a

¹¹³ MJ Cullen, *Tax And Charities A Government Discussion Document On Taxation Issues Relating To Charities And Non-Profit Bodies (Policy Advice Division, Inland Revenue Department, 2001 Wellington, NZ), 33*
charitable entity. The Court rejected the construction “I look for the object for which the company exists and I find it to be a commercial activity.”

2. Criminal liability

R v Anderson CA 367/03 22 September 2004 is the successful appeal from the District Court finding of criminal nuisance on the part of the organiser of the Bank’s Peninsula annual cycle race in which a participant was killed. The appeal succeeded on the basis that the standard of conduct should have been recklessness and not negligence.

In a more recent case, the chief executive of Rowing New Zealand was convicted of fraud in relation to the preparation of false invoices, using other people’s signatures and creating false minutes of meetings that were never held, in order to speed up funding applications that resulted in grants of $370,000. It was accepted that he did not benefit personally from the fraud and the conviction was overturned on appeal but only on the basis that the consequences of the conviction outweighed the level of offending.

3. Financial liability

In Commonwealth Bank of Australia v Friedrich (1991) 5 ACSR 115 an unpaid, voluntary director of an NFP was found personally liable to pay $97 million to a bank on the liquidation of the NFP, after the directors had signed off the company’s accounts as showing a true and fair view of the company’s financial position, not having properly considered the accounts and not having seen the auditors’ qualified opinion. The Court found that the directors would have had reasonable grounds for concluding that the company was insolvent and should have informed themselves at the time of the annual general meeting of the accounts and auditors’ report.

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4. Reasonable care, skill and diligence

In Dorchester Finance Co Ltd v Stebbing [1989] BCLC 498 the trustees of a charitable trust were found to have breached their common law obligations of care, skill and diligence in leaving the management of the company to a third trustee.

F Other Sources of Accountability and Redress

1. Ministerial

The highly publicised difficulties of a leading disability care provider illustrate the powers of the Ministry of Health to investigate organisations providing services that the Ministry has funded.

Focus 2000 Ltd ("Focus 2000") is a state funded disability care provider wholly owned by the Cerebral Palsy Society. During 2006 to 2008 the New Zealand Herald investigated complaints into the standard of care at Focus 2000 facilities and publicised concerns as to the level of reserves the company had accumulated, primarily from Ministry of Health payments for contracted services. The Ministry of Health conducted audits into the standard of care and into Focus 2000’s financial affairs and the Cerebral Palsy Society commenced High Court proceedings against the (suspended) chief executive officer of Focus 2000 and four former Focus 2000 directors, alleging that the actions of the directors in resolving to transfer $5 million from Focus 2000 to a newly created trust by way of an endowment fund were unlawful and in breach of the individuals’ responsibilities as directors. The new trust would have been outside the control of the Cerebral Palsy Society and Focus 2000. An interim board was put in place to run Focus 2000. The High Court proceedings were eventually settled. The president of the Cerebral Palsy Society attributed the problems to an outdated and ambiguous constitution.
At best the Society received an expensive lesson in governance, but at worst its relationship with its main funder was significantly impaired and public confidence in the organisations was damaged.\textsuperscript{116}

2. Philanthropic funders

New Zealand is unusual in that it has no legislation specifically governing fundraising.\textsuperscript{117} Funders such as Pub Charity rely on rights of audit in the terms and conditions of the grant application form\textsuperscript{118} and the requirement that evidence of the agreed use for the funds is provided within 3 months of the grant.\textsuperscript{119}

3. Contractual

The writer has reviewed standard form examples of Ministry of Health and Ministry of Social Development contracts for provision of disability and health services.\textsuperscript{120} These examples impose detailed record keeping requirements on the providers and reserve rights of audit to the ministries. Primary Health Care Organisations are also subject to the Primary Health Care Audit Protocol\textsuperscript{121} and the Governance Guide For Primary Health Organisations.\textsuperscript{122} Ministries’ monitoring regimes are also expected to comply with the Auditor-General’s Principles To Underpin Management By Public Entities Of Funding to Non-Government Organisations.\textsuperscript{123}

\textsuperscript{116} This information was obtained through a combination of (undated) articles retrieved from the http://www.nzherald.co.nz/focus-2000-investigation/new/print.cfm? website (accessed 22/09/08), from a discussion between the writer and the general manager of the Cerebral Palsy Society and from correspondence between the chair of Focus 2000 Ltd and a disability service recipient.

\textsuperscript{117} In contrast to the regime under the Electoral Finance Act 2007 in relation to political fundraising.


\textsuperscript{120} Agreement between the Ministry of Social Development and Standards and Monitoring Board dated 18 June 2008 “For the Purchase and Provision of Vocational Services for People with Disabilities (Developmental and Targeted Evaluations)”, agreement between the Ministry of Health and Standards and Monitoring Board dated 13 June 2008 for auditing services, Ministry of Health standard mental health contract and Ministry of Health standard Primary Healthcare Organisation funding contract.

\textsuperscript{121} Ministry of Health Primary Health Care Audit Protocol (Ministry of Health, Wellington New Zealand 2004).

\textsuperscript{122} Pete Hodgson, Minister of Health Governance Guide For Primary Health Organisations (Minister of Health, Wellington New Zealand 2007).

\textsuperscript{123} Controller and Auditor-General Principles To Underpin Management By Public Entities Of Funding to Non-Government Organisations (Office of the Auditor-General, Wellington New Zealand 2006).
The experience of the New Zealand NFP sector in dealing with state monitoring and reporting requirements is summarised by Deane above\textsuperscript{124} with the clear view that such processes are obstructive and counterproductive. Gregory O’Joborne however came to the opposite conclusion in relation to research he conducted into how effective internal and external governance mechanisms were in assisting large UK charities to achieve their objectives.\textsuperscript{125} His research concluded that:\textsuperscript{126}

The results suggest that government funding is positively associated with a higher ability of charities to redistribute funds to ultimate beneficiaries, one reason for which is likely to be the reporting and monitoring mechanisms that accompany such funding...another being the fund-usage restriction that such state funding usually imposes on recipient charities. The results also indicate that fund-usage restrictions by private donors, a traditional governance device, may also be efficiency - enhancing. Further, as predicted by agency thinking, private donors do not show a significant efficiency effect - suggesting that more dispersed private donors have less incentive to monitor managers. The adoption of business-type corporate governance mechanisms yields insignificant coefficients. On balance...these findings suggest a monitoring-driven agency framework, in which charity passthrough efficiency benefits from the use of (or access to) internal or external devices which strengthen reporting mechanisms and restrict managerial discretion.

4. Statutory schemes

(a) Dissolution

The provisions of the CTA and ISA dealing with dissolution of charitable trusts and incorporated societies respectively have been outlined above. These provisions have received limited interpretation by the courts, but two cases are of particular interest. The first is a decision of Asher J \textit{The Registrar Of Incorporated Societies v The Hearing Association Whangarei Branch Incorporated}\textsuperscript{127} in relation to an application under sections 25 and 26 ISA to put the association into liquidation on the basis that it would be just and equitable to do so (s25(e) ISA). The Registrar’s evidence was that that within 2 years of a

\textsuperscript{124} Dr Roderick Deane “Charities and Government” [2007] NZLJ 60.
\textsuperscript{125} Gregory O’Joborne “Public Funding, Governance and Passthrough Efficiency in Large UK Charities” (2006) 14 Corporate Governance 43.
\textsuperscript{126} Gregory O’Joborne “Public Funding, Governance and Passthrough Efficiency in Large UK Charities” (2006) 14 Corporate Governance 43,55-56.
new committee being appointed at the annual general meeting, the association had been grossly mismanaged with irregular transactions (such as sales of assets at undervalue to persons known to the president and the new committee) and a gross reduction in the assets of the association over that 2 years with the likelihood of insolvency.

Asher J considered the applicability of the jurisprudence in relation to the just and equitable ground under s241 (4)(d) Companies Act 1993 but noted that Cooke J said in *Finnigan v NZRFU* [1985] 2 NZLR 159,178 (in relation to *ultra vires*):

...the law or practice relating to limited liability companies is not necessarily a helpful analogy when considering the position of that incorporated society ‘where the raison d’etre of an organisation is not to make profits but to promote a certain activity’

Morris J adopted the same approach in considering an application to wind up an incorporated society on the just and equitable ground in *Hunt v Border Fancy Canary Club of NZ (Inc)*. He referred to *Finnigan* and said:

The same may be said for winding up an incorporated society on ‘just and equitable grounds’. Company law provides some guidance for the winding up of incorporated societies. It must be kept in mind [though] that often committee members are unpaid volunteers, with little or no professional training.

Asher J considered that two grounds in company law jurisprudence were relevant to this case - lack of confidence in the conduct and management of the company and oppressive or prejudicial conduct. This could include conduct by those in control of the association in breach of their fiduciary duty to it.

[12] the considerations that relate to incorporated societies may have a different focus to those relating to companies. For instance, the broader objectives of an incorporated society might mean that in addition to considering the interests of members, the Court could consider the expectations of donors or other interested parties. Therefore, the concept of lack of confidence can be measured against not only the interests and reasonable expectations of members, but also potential donors.

The Court found that there had been gross mismanagement and that there was a real risk of insolvency, although it did not go so far as to find impropriety on

128 *Hunt & Ors v Border Fancy Canary Club of New Zealand (Inc)* (2000) 8 NZCLC 262,140.
the part of officers and employees. It held that there were matters giving rise to
a loss of confidence in the conduct and management of the Association and
that its affairs were being conducted in a manner that was oppressive to those
members who were not in control of it. In these circumstances it was just and
equitable that the association be placed into liquidation.

The second case, *Peilua v The Evangelical Samoan Wesley Methodist Church
of Otahuhu Board* 129 concerned an application under s25 CTA to place a
charitable trust board in liquidation on the basis that it was just and equitable to
do so. Heath J considered the “just and equitable” ground and noted that it is a
touchstone for a wide variety of different corporate entities to determine whether
the entity should be place in liquidation.130

In this case, following a dispute within a congregation over the ordination of
openly homosexual men by the Methodist Church a group of members left that
congregation and established the respondent church board, in the process
purchasing property and raising tithes from the congregation to pay for the
property. A further dispute arose and a faction of the congregation (the
applicants) of the respondent church board removed themselves from the
congregation. They considered that the church board should be put into
liquidation and that the assets of the trust should be shared amongst the
original members of the board who had contributed to the acquisition of the
property through their tithes.

Heath J declined the application. He noted that membership and associated
tithing were voluntary. Members were aware that the purposes of the tithing
were to acquire the property and repay the mortgage. These members were
not excluded from the church but made a conscious decision to leave knowing
that the assets would continue to be used in same way. “With that knowledge,
the group who left are, in effect, attempting to recover gifts made voluntarily to

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the Church for religious purposes.”131 Also, those who remained continued to be under an obligation to contribute to the repayment of the mortgage.

In *Society of St Vincent de Paul v Wanganui Ozanam Villa Trust* [2007] NZAR 77 Allan J considered an application by the society to rescind an order for voluntary liquidation of the respondent charitable trust that had been obtained by the trustees. The society had previously purchased and settled a house on the trust. In granting the application the court held that the High Court had an inherent jurisdiction as a reserve or residual power to ensure the observance of the due process of law, prevent improper vexation or oppression and do justice between the parties. There was an inherent jurisdiction to set aside a winding up order obtained by fraud, improper means or if there was a miscarriage of justice.

**(b) Section 58 CTA**

Ultimate powers of accountability in relation to charities are conferred on the Attorney General under s58 CTA. Wide powers of investigation are provided, including powers under the Commissions of Inquiry Act 1908. These powers were exercised in the Centrepoint commune dispute. The Centrepoint Community Growth Trust was incorporated under the CTA in 1977. In 1989 and 1992, 13 members of the commune were convicted and imprisoned for drug offending, perjury and sexual offending against children. Serious internal dissent followed over the operation of the trust and the supervision of the Court was invoked under the CTA. The Attorney-General conducted an inquiry under the CTA and the resulting negative conclusions as to the administration of the trust and achievement of its charitable purposes were followed by the appointment of the Public Trustee in 1997 to act as trustee of the trust pursuant to s51 CTA.132

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5. Judicial Review

Judicial review will provide a remedy to third parties affected by unlawful decisions of incorporated societies (and by extrapolation, to other bodies incorporated under statute). The Court of Appeal in *Stratford Racing Club v Adlam* [2008] NZAR 329 granted judicial review of decisions of the committee of the Stratford Racing club made outside the rules of the club. The club committee had resolved to transfer its racecourse to a charitable trust with provision for it to be operated for the benefit of the Stratford community. In the event of winding up of the trust, any surplus assets were to be distributed for charitable purposes within the Stratford community. The club had no power to appoint trustees to the trust. The decision was motivated by a concern that the Racing Industry Board intended to appropriate the property as part of a rationalisation process. A group of opponents sought membership of the club to challenge these decisions but their applications for membership were rejected, as was the application of an existing member to join the committee.

The Court of Appeal held that the club had acted outside the purposes set out in its rules and subsequent approval at a general meeting could not validate such an act. The club’s decision to blackball membership applicants was amenable to judicial review because the applicants could not rely on a claim in contract based on the rules. The committee had failed to act in good faith and to exercise its powers in the best interests of the club.


Obligations to volunteers is a significant issue for NFPs, given their reliance on voluntary assistance. The Health and Safety In Employment Act 1992 has been amended twice to deal with the issue of protection of volunteers. As originally drafted the act provided cover for volunteers but following the *Berryman* decision it was thought that farmers, amongst others, were exposed to unacceptable risk in relation to recreational users of their land. S16 of the Act...

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133 Zaman v South Auckland Muslim Association [2004] NZAR 559.
135 Department of Labour v Berryman [1996] DCR 121.
was amended in 1998 to exclude volunteers in workplaces. In recognition of this gap in coverage, in 2002 the Act was further amended and this time a halfway house of coverage for volunteers was implemented, so that volunteers effectively doing the work of an employee, but without pay are deemed employees (with some exceptions) for the purpose of cover. Volunteers whose role does not amount to that of an employee have more restricted protection under section 3D of the Act.

Thought had been given at a policy stage to excluding volunteers working for NFPs from the Act, but this idea was dropped given the numbers of volunteers involved in the sector.

7. Charities Commission

The functions of the Commission are set out in section 10 (1) of the Charities Act 2005 (“CA”) and relate to all charities, regardless of whether they are registered under the CA. The functions include the promotion of public trust and confidence in the charitable sector and the education and assistance of charities in relation to good governance and management. Specific functions in relation to monitoring and compliance are also included:

(i) [to] monitor charitable entities and their activities to ensure that entities that are registered as charitable entities continue to be qualified for registration as charitable entities; and
(j) [to] inquire into charitable entities and into persons who have engaged in, or are engaging in, conduct that constitutes, or may constitute a breach of this Act or serious wrongdoing in connection with a charitable entity, and
(k) [to] monitor and promote compliance with this Act, including by taking prosecutions for offences against this Act in appropriate circumstances…

The Commission has the power to remove an entity from its register on the grounds set out in section 32 CA, including persistent failure to comply with the CA or any other statute.

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137 S 10 (1) (a) and (c) Charities Act 2005.
It is an offence for any person to hold out that it is a registered charitable entity if this is not the case (section 37 CA). The penalty for breach of s37 is potentially quite significant with a maximum fine of $30,000.\footnote{S 38 Charities Act 2005.}

Charitable entities are required to provide annual returns in the prescribed form.\footnote{S 42 Charities Act 2005.} No specific penalties are provided for breach, but the failure would expose the entity to the possibility of removal from the register.

The Commission has wide powers of investigation under section 50 CA, including the power to require third parties to provide relevant information (section 51 CA).

The Commission also has powers to issue warning notices\footnote{S 54 Charities Act 2005.} in relation to conduct that may be in breach of the Act, or otherwise constitutes serious wrongdoing,\footnote{S 4 Charities Act 2005.} and to publish details of the conduct in question if it is not remedied following the notice.\footnote{S 55 Charities Act 2005.}

The focus in the CA on the compliance role of the Commission has been criticised,\footnote{Institute of Chartered Accountants of New Zealand Charities – The New Environment (Institute of Chartered Accountants of New Zealand, Wellington, 2004).} noting that the provisions seemed to be overly harsh and tax compliance driven. In this writer’s view however, the expense and uncertainty of legal proceedings and the limited options available to the Court under the ISA and CTA are such that it is appropriate that the Commission has broad powers. Hopefully those powers will be used with an educational focus, much in the same way that the Health and Disability and Privacy Commissioners operate.

8. Health and Disability Sector Governance

In the health and disability sector in New Zealand accountability and redress are provided to service recipients through legislation and regulation, with an
independent commissioner charged with the responsibility for investigating and reviewing complaints in relation to health and disability services.\textsuperscript{144} This process is limited in that it does not give consumers, or prospective consumers any rights in relation to access to services or in relation to the planning of, and budget allocation of, services. It was also noted that in relation to the disability sector, the process is inadequate and recommendations have been made for a new agency to be established, solely for the disability sector, to improve accountability.\textsuperscript{145}

Although the New Zealand Public Health and Disability Act 2000 references to public consultation and engagement were initially interpreted broadly,\textsuperscript{146} the Court of Appeal has more recently adopted a significantly more restrictive approach.\textsuperscript{147}

9. Reputation

The most important asset any NFP has is its reputation. Regardless of complaints to the Commission or legal proceedings, NFPs are to a large extent reliant on good will, in particular on the good will of funders, both state and private. A compelling reason for ensuring good governance practices is to minimise the risk of damage to that reputation and to maximise open and transparent relationships with stakeholders.


\textsuperscript{145} Report of the Social Services Committee Inquiry Into the Quality of Care and Service Provision for People With Disabilities (September 2008)

\textsuperscript{146} Diagnostic Medlab Ltd v Auckland District Health Board [2007] 2 NZLR 832.

\textsuperscript{147} Lab Tests Auckland Ltd v Auckland District Health Board [2008] NZCA 385.
VI SUGGESTIONS FOR REFORM

The suggestions for governance-related reform in the NFP sector neatly illustrate the two dimensions of governance – internal and external – discussed above. The problems identified relate both to the restrictions that the law and other governance processes place on NFPs, adversely affecting their ability to achieve their mission, and to the lack of accountability under current law.

The first camp of commentators focuses on aspects of the legal process that restrict the NFPs from achieving their purpose. Kerry O’Halloran in *Charity Law and Social Inclusion* examines the role of the law in relation to charities in supporting the needs of the socially disadvantaged in a number of common law countries and concludes that the law is in need of an overhaul and update:

...charity law more so than any other legal framework is explicitly stamped with the obligation to address the needs of the socially disadvantaged. It it’s not to fail in its central mission, the law governing philanthropy in all its modern guises must now be made to fit contemporary manifestations of need, domestic and global. The legal framework regulating the philanthropic environment could facilitate a more effective contribution of charitable resources for the alleviation of poverty and the encouragement of social inclusion. At the very least, existing obstructions should be removed.

O’Halloran goes on to consider the contemporary NFP relationship with governments, describing the relationship as one of partnership between the state and the third sector, with charity law as the framework and suggests that:

[...]here can be little doubt, however, that these new formal arrangements offer the best chance of building more stable, cohesive and engaged societies within which the needs of the socially disadvantaged can be readily acknowledged and accountability for failure to address them swiftly ascertained.

This approach places accountability firmly in the hands of the state funder. Contractual accountability is indeed a swift means of redress- failure to provide

contracted services to a contracted standard should result at some point in withdrawal of funding and closure of the service.

But contractual modes of engagement can also act as a fetter on the NFP’s autonomy, in particular where contracting is short term and the entity’s future planning is dependent on renewal of contracts. (Grants for specific purposes can also in one sense limit the independence of the entity in terms of use of that revenue, but a significant difference is that the NFP would usually have allocated the funds to a desired purpose in preparing the grant application).

Alison Dunn\textsuperscript{151} notes the historic role of the charity sector in England in advocating for social reform and the inherent conflict that arises when the advocacy is in relation to the policies of the sector’s main funders. This issue and the related problem of the restricted definition of “charitable purpose” were raised in a number of submissions to the New Zealand Social Services Select Committee in relation to the Charities Bill.\textsuperscript{152} The issue was that advocating for political change is not accepted as a charitable purpose and a number of submitters were concerned that this role would affect their charitable status. The Select Committee noted that the common law allowed non-charitable secondary purposes and recommended that this aspect of the common law be codified. This recommendation was adopted and section 5 CA expressly provides that inclusion of non-charitable purposes does not affect the entity’s registration as a charitable entity. The definition of “charitable purpose” was not however amended, the Select Committee noting that it was not the purpose of the new legislation to change the law, and suggesting that the Charities Commission could review the issue itself in time.

Other commentators identify further problems with the restrictive nature of New Zealand’s law. Thomas Gibbons\textsuperscript{153} suggests that the ISA and CTA are inadequate pieces of legislation, lacking the default provisions of the Companies Act 1993 in relation to a constitution, and providing little direction or


\textsuperscript{152} Social Services Select Committee Report Charities Bill 108 - 2.

guidance. He notes in particular the complicated process involved in establishing a charitable trust in comparison to a company and the duplication of requirements\textsuperscript{154} in relation to rules changes, under the CA and CTA. He concludes, as does O’Halloran, that the law should do more to facilitate the role of charities.

Hansmann\textsuperscript{155} identifies the problems that the NFP model creates in relation to the raising of equity and the corresponding reliance on donations, retained earnings and debt for capital financing:\textsuperscript{156}

The funds available from these sources may, however, be poorly matched to the capital needs of the organization. Donations may merely reflect the whim of contributors. Sufficient retained earnings to finance major capital expansion may take too long to accumulate and of course are not available at all to a newly founded organization. Debt financing, which generally is available for only a fraction of the investments made by for-profit firms, is even more limited for non-profits because of the poor fungibility of the organization’s assets and the negative effect on the creditor’s public relations in case of foreclosure.

The second camp of commentators focuses on the inadequacies of the law in terms of controlling NFPs and ensuring accountability.

Gousmett\textsuperscript{157} queries the relevance of the presumption of a perpetual trust and considers that it is part of the governance role of trustees to constantly consider whether the objectives of the trust remain relevant and whether the trust can achieve them economically. He links this to the tax exempt status granted to registered charitable entities and suggests that this obliges trustees to ensure that the trust continues to be of value to society. Nick Bland\textsuperscript{158} also discusses the tax exemption provisions for charities, noting the confusion in their application and related compliance and governance issues for the entities and their boards. He suggests that tax exemptions should be limited to those organisations that also have approved donee status with the Department of Inland Revenue, or indeed only to those registered with the Charities Commission.

\textsuperscript{156} Henry B Hansmann “The Role of Nonprofit Enterprise” (1980) 89 Yale Law Journal 835, 877.
\textsuperscript{157} Michael Gousmett “Governance of Charities” [2008] NZLJ 106.
\textsuperscript{158} Nick Bland “Tax and Charities” [2008] NZLJ 117.
Other authors have raised concerns as to the lack of regulation around financial affairs. O’Halloran\(^{159}\) and Gino Dal Pont\(^{160}\) both identify the lack of regulation of fund raising in New Zealand, a position that contrasts with that of other common law jurisdictions. David McLay\(^{161}\) notes that there are no financial disclosure requirements for the NFP sector and that the Charities Commission does not yet require any particular form of financial reporting. He suggests that the sector needs to show some leadership on this issue, given that both the Ministry of Economic Development and the Accounting Standards Review Board have issued statements and proposals as to financial reporting by NFPs. Susan Woodward\(^{162}\) considered the policy issues of financial disclosure in conducting research on Australian NFP companies, noting the public’s interest in disclosure given the advantageous taxation provisions for NFPs and also the fact that the public’s confidence as donors rests on a high degree of accountability. Against this is the additional time and expense that a further layer of regulation would impose on NFPs.

Agmen-Smith and von Dadelszen\(^{163}\) note the lack of an equivalent in the CA to the deemed officer provisions of the Companies Act, particularly relevant given the research and agency theory surrounding the role of management in NFPs.

England has addressed some of these issues by developing a new form of NFP entity, the Community Interest Company (“CIC”), for organisations combining NFP purposes with commercial activities. CICs are incorporated under the English companies legislation and must comply with companies and insolvency legislation, and accountancy and governance requirements in the same way as other UK companies. They are designed to be quick, easy and inexpensive to establish with a model memorandum and articles of association provided by the relevant regulator. The advantage for the CICs is that they can raise capital in the same way as other companies with the added protection of the limited

160 Gino Dal Pont, Charity Law in Australia and New Zealand (Oxford University Press, Melbourne, Victoria, 2000).
liability of the company structure. An “asset lock” is mandatory, preventing the CIC from disposing of its assets for less than their market value, protecting against inappropriate payments to directors and members. Tax advantages are not available to CICs and in return regulation is light, although financial disclosure requirements are specified, seeking to maintain a balance between minimal regulation and maintaining confidence in the CIC brand.164

A second vehicle, the “CIO” or Charitable Incorporated Organisation, is also proposed. The CIO would be more akin to the New Zealand incorporated society, with restrictions on distributions to members, reduced risk of personal liability, fewer reporting requirements than companies, but with an asset lock and a clear disclosure and governance regime through the Charities Commission.165

New Zealand in contrast is not in need of further legal vehicles. Rather, the sector needs a shakeup in terms of its understanding of governance responsibilities and its governance performance. The irony in New Zealand is that if the Charities Commission does proceed to raise the level of monitoring and compliance within the sector, a casualty may be those NFPs who are operating outside their legal purposes, thereby becoming caught in the definitional issue discussed above.

An ongoing issue for the sector is the difficulty faced by NFPs in securing financial stability. This could be addressed by state and philanthropic funders by extending the term of contracts and grants for NFPs who are able to provide sufficient governance assurance. Dialogue is needed within the sector to identify how that assurance can be manifested.

On the basis of Cribb’s research it does not appear that the sector itself perceives value in the apparently heavy-handed monitoring processes of the state funder, but O’Joborne’s research suggests that in fact the sector does

benefit from these processes. This is the position adopted by O’Halloran too, assuming that a genuine relationship of partnership can be achieved. In the absence of an effective umbrella organisation for the sector, it appears that the direction of governance will be determined by the state as funder and in the form of the Charities Commission, rather than by NFPs themselves.
New Zealand’s governance of the NFP sector is in a state of transition, with the full role and potential of the Charities Commission as yet undetermined. The value and significance of the sector, economically, socially and politically, is however clear with successive governments extending the role of the sector and the state’s reliance on the sector for service provision.

With that expanded role go heightened expectations of accountability and transparency and it is these features of governance in the sector which are likely to receive the focus of the Charities Commission, once its registration processes are complete. New Zealand has an indigenous mix of law and regulation for NFPs, with a hybrid of tax law, the incorporated societies, charitable trusts and (to a lesser extent) companies laws and related case law supporting the whole. On top of this hybrid the monitoring function of the Charities Commission has been imposed.

Returning to Farrar’s concentric rings concept of governance, the element that is missing from the sector is self regulation, given the core law and the strong sense of mission that characterises the sector. This is unsurprising given the lack of an effective umbrella organisation to represent the sector. This is particularly evident in relation to financial disclosure requirements, none exist at present but there is apparently no voice on this issue on behalf of the sector, with pressure instead coming from the Ministry of Development and the Accounting Standards Review Board. The likely outcome is that some amalgam of their recommendations, following the English model of a sliding scale of disclosure, will be effectively made a requirement through the Charities Commission.

Perhaps this state of affairs reflects the underlying reality of a sector reliant on external funding. Funders will always drive financial accountability as in fact do consumers and shareholders in the commercial world. The role of the wider stakeholder group is to drive mission-accountability, ensuring that the NFP in
question achieves or at least considers the wishes and needs of its particular community. This has been difficult in New Zealand in that remedies available under the CTA, ISA, the Companies Act 1993 and at administrative law are cumbersome sources of redress, even putting to one side the expense and uncertainty of the outcome of legal proceedings.

The Charities Commission does however have a wide role and can follow up third party complaints. Ideally it will adopt a similar approach to the Health and Disability, Privacy and Human Rights commissions, with a dual focus on performance and conformance, providing education and leadership as well as accountability. This will hopefully foster improved governance within the sector and give the sector a base from which to influence its relationship with funders, both state and philanthropic.

The role of the governing body of the NFP is complex. The interests of a range of stakeholders must be balanced to ensure financial stability and mission-focus. NFPs need a range of skills and networks to achieve this balance. This is the foundation of the NFP governance hybrid and the challenge for NFP governors.
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