

# Guidance Booklet

## Charity Incorporation Made Simple



PROMOTING BEST PRACTICE  
IN CHARITY FINANCE

## Contents

What is an incorporated charity?	1
What are the key features of an incorporated charity?	2
What is an unincorporated charity?	3
Advantages and disadvantages of incorporated charities	4
Advantages and disadvantages of unincorporated charities	5
What is the legal position when a trustee ceases to be a trustee?	6
What is a trust corporation?	6
What are the risks associated with having individual trustees of an unincorporated charity?	7
How can the risks associated with having individual trustees be dealt with?	8
Incorporating the charity as a whole	8
Incorporating the trustee body	9
Trust company	9
A certificate of incorporation	10
Steps to be taken following incorporation	11
Land	11
Investments	11
Further information	13

This booklet deals with trustee liability for trustees of unincorporated charities. It provides information about the nature of incorporated and unincorporated charities and how to manage risk appropriately.

## Key points

Individual trustees of unincorporated charities enter into contracts on behalf of the charity in their personal capacity and so they are exposed to personal liability under those contracts. Although a trustee in good standing has a right to be indemnified from the trust fund, this is only adequate protection if the trust fund is sufficiently large to cover the liability in question.

When a trustee ceases to be a trustee he/she will continue to be personally liable under the contracts that he/she entered into and so it is important that these contracts are assigned or novated. Where the trustees of an unincorporated charity enter into a significant number of contracts which impose obligations it is worthwhile to consider the benefits of incorporating either the charitable entity as a whole or the trustee body of the unincorporated charity.

An incorporated charity has separate legal personality and so can enter into contracts in its own name. The trustees, in their role as directors of the company, will be protected from personal liability provided they act properly. Incorporation will require the transfer of certain assets to the new corporate body and will increase the administrative burden on the charity. Once the incorporated charity is established, however, its separate legal identity means that there is no longer any need for contracts to be assigned or novated when trustees retire.

## What is an incorporated charity?

An incorporated charity is a charity which is a body corporate. The most common form of incorporated charity is a private company limited by guarantee. Such a company has no share capital but the members provide a guarantee that they will be liable (up to a nominal sum of £1 or £10) to the extent that there are liabilities after the company has been wound up while they are still members (or within a year afterwards). Other examples of incorporated charities include an industrial and provident society and an incorporated friendly society established to relieve poverty. Once the Regulations establishing it have been passed, the new Charitable Incorporated Organisation ("CIO") will be an incorporated charitable body.

A charity may be founded by Royal Charter or an existing charity may be granted a Royal Charter. The Royal Charter incorporates either the charity itself or the trustee body of the charity.

## What are the key features of an incorporated charity?

A corporate body has separate legal personality. This means that contracts or other transactions can be entered into in the name of the corporate body by its directors or other authorised signatories. A director of a company will not be personally liable except in certain restricted circumstances. These are, broadly:

- \* where a director signs or authorises the signature on behalf of the company of a cheque or other order for payment in which the company's name is not mentioned, he is personally liable for the payment due by the company if the company does not pay;
- \* under the insolvency legislation, if a director is found guilty of fraudulent or wrongful trading, the court may order the director to make a personal contribution to the company's assets;
- \* a director enters into a contract on behalf of the company if he has no ostensible, actual or apparent authority to do so, he may be liable to the party to the contract for breach of warranty of authority;
- \* if a director makes a profit as a result of a transaction with the charity, for example the sale of his/her own property to the charity, he/she must account to the charity for that profit. Except where the constitution permits it or the statutory power for charity trustees to receive remuneration applies, it is a general principle of charity law that directors of all charities, including charitable companies, must act gratuitously. If a director takes any unauthorised benefit as a result of acting as a director he/she will need to account to the company for any sums obtained;
- \* in cases of negligent misstatement, where a director takes personal responsibility for a statement made to a third party and the third party relies on the statement to its detriment he/she will potentially be personally liable in damages;
- \* where a company goes into liquidation, if a director has misapplied any money or other property of the company or has breached his/her duties, the court has power to order a director to account for such money or property or to pay compensation to the company;
- \* where a director breaches certain statutory duties, for example duties under health and safety legislation, he/she may be personally liable to a penalty; or
- \* where a director fails to comply with provisions of the Companies Acts, for example by failing properly to keep the register of directors and secretaries, the register of members, by not registering charges at Companies House or by failing to file accounts, he/she may again incur a personal penalty.

If a director is or may be personally liable for a breach of trust or breach of duty but he/she has acted honestly and reasonably and ought fairly to be excused for the breach of trust or duty, the Charity Commission or the court may make an order relieving him wholly or partly from liability. Conditions may be attached.

## What is an unincorporated charity?

An unincorporated charity is a charity which is not incorporated. An unincorporated charity can take many forms, including a charitable trust and a charitable unincorporated association. A charitable unincorporated association is not dissimilar to a members' club and consists, broadly, of a group of individuals who have come together to further a particular charitable purpose. The association is normally governed by a committee. The most common form of unincorporated charity, however, is a charitable trust. A traditional charitable trust is created by a person who transfers funds to trustees to hold on trust for exclusively charitable purposes. An unincorporated charity is not a distinct legal entity - for example, a charitable trust is merely an obligation on certain persons to hold property for charitable purposes. The charity itself cannot be a party to contracts because it does not have separate legal personality. A charitable trust operates through its trustees, all of whom enter into contracts in their personal capacity. Any claim, for example, an employment claim or a claim arising from a breach of a contract, is brought against the trustees personally. The trustees are, therefore, in principle, personally jointly and severally liable for contracts entered into on behalf of the charity unless it is agreed that the trustees' liability be limited. Trustees are personally liable on contracts whether or not they act beyond their powers or if they act in breach of trust, but if they are acting outside their powers or otherwise in breach of trust they are not entitled to any indemnity from the trust property. Such liability could, in principle, arise where, for example, the trustees commit to payments for services in anticipation of grant-funding which is not received.

Trustees of charitable trusts are entitled under general equitable principles to be reimbursed from the trust fund or to make payments directly out of the trust fund for expenses properly incurred by them when acting properly on behalf of the trust. Broadly, this means that, provided the trustees act reasonably and in accordance with the charity's governing document and the trust fund contains sufficient monies, the trustees will not have to bear the expenditure personally. However, if the trust fund is insufficient or the trustees are dishonest or negligent, they may find themselves personally liable. As a result, a trust is particularly suitable for non-operational charities where the trustees do not take commercial risks, for example large grant-making charities.

The funds of a charitable unincorporated association, unlike the funds of a private club (which belong to its members), are held on trust for the purposes of the association. Members of the governing body of a charitable unincorporated association are also, therefore, in principle entitled to an indemnity from the association's funds. However it is helpful to include a clear rule in the association's constitution that allows for an indemnity from the association's funds.

Another feature of unincorporated charities relates to the ownership of property. Where real property belongs to unincorporated charities, it must be held in the names of the trustees. Unlike the position with a private trust, there is no maximum number of trustees but it is usual to limit the number actually registered as proprietors to four.

### **Advantages and disadvantages of incorporated charities**

The main advantages of having an incorporated structure are:

- ★ An incorporated charity can enter into contracts in its own name rather than in the names of the trustees. This is particularly important where a charity enters into significant numbers of contracts, employs large numbers of people or acquires premises, as it reduces the scope of personal liability on the part of the trustees.
- ★ A corporate body is a useful vehicle where it is expected that the charity will have a membership structure. It gives flexibility in that the members and the directors may be the same people (as is the case with many smaller operational charities) but also allows for a larger membership separate from the directors (as is the case with, for example, charities which support particular professions).

The main disadvantage of being a company is that it involves the need to comply with company law as well as charity law. It is necessary to file returns with both Companies House and the Charity Commission, for example when the Articles of Association are amended or when the annual report and accounts are produced.

## Advantages and disadvantages of unincorporated charities

The main advantages of an unincorporated structure (for example, a charitable trust or a charitable unincorporated association) are:

- \* A trust is particularly suitable where a founder wishes to exercise some control over how the funds will be applied in the future or, for instance, to appoint trustees during his/her lifetime.
- \* A trust is the only structure which can restrict the expenditure of capital and can, therefore, stipulate that the income only may be spent.
- \* An unincorporated association is suitable for small, informal organisations which may have a committee as well as a membership and which do not intend to employ more than a few members of staff or enter into numerous other contracts.

The main disadvantages of an unincorporated structure are:

- \* A trust is not a suitable entity where a membership is desired. This is because a trust acts only through its trustees and it is unwieldy to have within a trust the dual structure of members and directors which a company has. That said, a charitable unincorporated association is a suitable unincorporated vehicle where a membership is desired, although that form is not so suited to the holding of permanent capital.
- \* The trustees (including the charity trustees of a charitable unincorporated association) are personally liable in relation to contracts entered into on behalf of the trust/association and will remain so even once they cease to be trustees unless the contract is terminated or novated. The indemnity will not assist them if the charitable funds are insufficient, even if they have acted perfectly properly.
- \* The unincorporated form is inconvenient for the holding of real property (unless a corporate trustees such as the Official Custodian for Charities is used) or for entering into numerous transactions.

## What is the legal position when a trustee ceases to be a trustee?

When a trustee ceases to be a trustee, he/she remains a party to contracts entered into while he/she was a trustee. He/she remains entitled to enforce the contract and is subject to the obligation to comply with the terms of the contract applicable to the charity). He/she will remain liable, subject to the right to be indemnified from the trust fund, if the successor trustees do not comply with the obligations contained in the contract.

In general a trustee who has retired from the trust will not be discharged from his/her duties towards the trust unless there will remain either a trust corporation or at least two trustees or the trust deed provides expressly for him/her to be discharged. There are certain limited situations governed by statute where the trust property will vest automatically in the continuing trustees, as joint tenants, for example, where a trustee retires by deed and obtains a discharge and a new trustee is not appointed.

### What is a trust corporation?

While a company may be appointed as a trustee it is not automatically a trust corporation. A trust corporation means the Public Trustee (who cannot act as a trustee of a charity) or a corporation granted trust corporation status under the rules made pursuant to the Public Trustee Act 1906 or appointed either by the court or by the Charity Commission, as a sole or custodian trustee. The main advantages of a trust corporation are that a trust corporation can give good receipt for capital monies arising from the sale of land.

Ordinarily the contract in question would need to be assigned or novated in favour of the new trustee body. An assignment of the contract will only transfer the benefit of the contract to the new trustee body. An assignment is therefore not sufficient to extinguish the personal liability of the outgoing trustees as it will not transfer the burden of the contract.

Novation is an alternative to assignment. It provides for the contract to be “renewed” so that the new trustee body would take over all of the rights and obligations under the contract from the date of the contract. Unless specifically provided for, past liabilities would remain with the original contracting parties. Novations should provide for past liabilities to be taken over by new successor trustees and should release the original contracting parties.



## What are the risks associated with having individual trustees of an unincorporated charity?

If an unincorporated charity has individual trustees and contracts are not assigned or novated following the retirement or appointment of a trustee or trustees, then the parties to the contract (including, in this case, the retired trustees) will remain liable on the contract. Although they are entitled to an indemnity, that indemnity is only as helpful as the value of the trust fund. If the trust fund is insufficient and a liability arises on the contract, the trustee in question may find himself/herself personally liable.

Where contracts are not assigned or novated and the trustees wish to enforce a contract in the courts the current trustees of the charity would need to locate the trustees who were party to the contract, which may delay matters.

## How can the risks associated with having individual trustees be dealt with?

There are a number of ways of dealing with this issue.

### Incorporating the charity as a whole

This usually involves establishing a new charitable company limited by guarantee and then transferring the assets and activities of the unincorporated charity to the new charitable company. Consideration would need to be given to the objects of the new charitable company. If the objects of the company were wider than the objects of the unincorporated charity, the company would hold any assets transferred to it upon trust for the objects of the unincorporated charity. Practically speaking, this would mean that if the unincorporated charity were established to relieve poverty in Devon and the new company were established to relieve poverty in South West England, any assets transferred from the unincorporated charity to the new company could only be used for the purpose of relieving poverty in Devon.

If the unincorporated charity holds designated property (being property required for the purposes of the charity for example, in the case of a recreational charity, the recreational land itself), a scheme of the Charity Commission would be required to transfer the property of the unincorporated charity to the new company. The new company would hold that property on trust. Generally speaking, land transferred from the unincorporated charity to the company would not require compliance with section 36 of the Charities Act 1993 as a transfer between charities at less than market value is outside the scope of that section (see section 36(9)).

In these circumstances, the charity trustees of the unincorporated charity usually become the directors of the charitable company limited by guarantee. As directors of a charitable company, these individuals would have limited liability as the company is an incorporated body and has separate legal personality. Following the transfer of assets from the unincorporated charity to the new company, the unincorporated charity may be dissolved. (It may be desirable for it to remain in being to collect any future legacies.)

The incorporation of a new company in the manner described above has the advantage of giving the directors limited liability. However, the key disadvantage is the need to transfer all the assets from the unincorporated charity to the company, which involves identifying the relevant assets and transferring them to the new body. There are certain statutory provisions which may make the process of transferring the assets easier.

The Charities Act 2006 expanded existing provisions to create a new power for trustees of unincorporated charities only which have gross income of less than £10,000 per year and do not have designated property, allowing them to transfer all their property to another charity provided that they are satisfied that it is expedient in the interests of furthering the transferor charity's purposes. As part of this procedure, the charity trustees may apply to the Charity Commission for an order vesting any property of the transferor charity in the transferee charity. The order would remove the requirement to transfer property separately.

The Charities Act 2006 also contains new provisions on charity mergers. A merger includes a situation where one charity transfers its property to another charity, the former of which then ceases to exist. The Charities Act 2006 allows the charity trustees of the transferor charity to execute a vesting declaration in relation to a charity merger. The vesting declaration operates to vest the legal title to all of the transferor's property in the transferee without the need for any further document transferring it. However, excluded from the scope of a vesting declaration are the following:

- \* land held by the transferor as security for money subject to the trusts of the transferor (with certain exceptions);
- \* any land held by the transferor under a lease or agreement which contains any covenant against assignment of the transferor's interest without the consent of some other person, unless that consent had been obtained; and
- \* any shares, stock, annuity or other property which are only transferable in books kept by a company or other body.

## Incorporating the trustee body

As an alternative to incorporating the charity in the manner described above, it is possible to incorporate the trustee body of the charity. This can be done by:

- \* incorporating a private limited company to act as trustee; or
- \* incorporating the trustee body pursuant to the Charities Act 1993.

Incorporating the trustee body of an unincorporated charity results in the trustees together becoming an entity which has separate legal personality. The charity itself would remain unincorporated. Details of both methods of incorporation are set out below.

### Trust company

A trust company is usually either a private company limited by shares or a private company limited by guarantee (which may itself, but need not, be a charity). It acts as trustee of the unincorporated charity. Generally, the directors of the company would also be the members of the company (or shareholders in the case of a company limited by shares). The constitution of the unincorporated charity may need to be amended so that it provides the mechanics for having an incorporated trustee. The trust company (acting through its directors) would act as the trustee of the unincorporated charity following the retirement of the individual trustees.

The Charities Act 1993 contains a definition of “charity trustees” as the persons having the general control and management of the administration of a charity. Where a trust company has been established, the charity trustee of the charity would be the trust company itself and not the individual directors of the trust company.

The main advantage of setting up a trust company is that it gives the directors of the trust company limited liability, because the company has separate legal personality. Another advantage is that it is possible to put a trust company in place without making substantial amendments to the governing document of the unincorporated charity. However, when the trust company is incorporated, it is necessary to assign or novate contracts into the name of the trust company, as new trustee. However, assuming that the trust company remains in place for the future of the charity, there will be no need for further assignment or novation.

The trust company would be considered to be a sole trustee, so it would need to apply for trust corporation status if it was intended that real property would be sold. In order to do this it is necessary to apply to the court or the Charity Commission.

### **A certificate of incorporation**

The trustees of the charity could apply to the Charity Commission for a certificate of incorporation under Part VII of the Charities Act 1993. The Commission has power to grant the trustees a certificate of incorporation if the Commission considers that incorporation would be in the best interests of the charity. On the grant of the certificate the trustees of the charity will become a body corporate with whatever name is specified in the certificate and the rights or liabilities of the individual trustees will become rights or liabilities of the incorporated body. On the grant of the certificate all the property of the unincorporated charity will vest in the incorporated body. However, it must still be transferred into the name of the incorporated body.

There are varying views on whether the grant of a certificate of incorporation provides limited liability to the trustees of a charity and there is no legal authority on this point. The Charity Commission is of the view that it does not give limited liability while other commentators are of the view that it avoids the issue of personal liability because any contractual commitments are entered into by the corporate body itself and not the individual members of it.

## Steps to be taken following incorporation

Although the trust property may vest in the new body, it will still be necessary to transfer certain property into the name of the incorporated body. The following steps<sup>1</sup> are likely to be required to be taken in relation to certain types of property in cases where the charity itself is incorporated, where a certificate of incorporation is obtained or where a trust company is established:

### Land

Leasehold interests would need to be assigned to the incorporated body. Where the trustees hold registered land, it is necessary to apply to the Land Registry for the register to be amended in relation to each title number. Where a new trustee is appointed to hold the trust property (whether a trust company is established or a certificate of incorporation is granted) the Land Registry would need to be supplied with details of the new trustee so that the Title Register of the charity's property can be changed.

Where a new charitable company is established, any land would need to be transferred to it.

If the land is unregistered, the transfer of land from the unincorporated charity to the charitable company (including where two charities merge) will trigger the requirement for first registration with the Land Registry. The appointment of a new trustee (being either a trust company or an incorporated trustee body) to hold the land on trust for the charity will also trigger first registration.

### Investments

A stock transfer form will need to be signed to transfer shares or other securities. Investment management agreements should be assigned or novated in favour of the incorporated body or trust company. Custodian or nominee agreements should also be assigned or novated in favour of the incorporated body or trust company.

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<sup>1</sup> In all cases legal issues relating to stamp duty land tax, stamp duty and VAT will need to be considered. An analysis of these issues is outside the scope of this booklet.

## What is a custodian trustee?

A custodian trustee is a trustee appointed for the purpose of holding assets only. A custodian trustee plays no part in the running of a charity, but must act on the instructions of the managing trustees, except to the extent that this would involve a breach of trust.

The Official Custodian for Charities is a corporation sole, and the office is held from time to time by an officer of the Charity Commission. The Official Custodian acts as a holding trustee without any powers of management. The charity trustees may act in his/her name and on his/her behalf. An order of the court or the Charity Commission is required to vest property in the Official Custodian.

## Contracts

Large contracts should be assigned or novated in favour of the incorporated body or trust company. With smaller contracts, trustees may take the view that it is easier to terminate them in accordance with their terms and enter into a new contract with the incorporated body or trust company as contracting party.

## Further information

### Land Registry practice guide - Charities

<http://www1.landregistry.gov.uk/assets/library/documents/lrpg014.pdf>

### Charity Commission guidance - Charities and Risk Management

<http://www.charity-commission.gov.uk/investigations/charrisk.asp>

### Charity Commission guidance - Incorporation of Trustees

<http://www.charity-commission.gov.uk/publications/cc43.asp>

### Charity Commission Guidance - Incorporating an existing company - Questions and answers.

<http://www.charity-commission.gov.uk/supportingcharities/incqanda.asp>

### Charity Commission operational guidance - Incorporation of Charity Trustees

<http://www.charity-commission.gov.uk/supportingcharities/ogs/index050.asp>

### Charity Commission operational guidance - Corporate Trustees

<http://www.charity-commission.gov.uk/supportingcharities/ogs/index038.asp>

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CFDG (Charity Finance Directors' Group) is the professional body for finance directors within the sector, and has over 1,600 members. CFDG provides assistance to charities on a range of issues, such as accounting, taxation, audit and other finance-related functions. CFDG's mission is to deliver services that are valued by members and enable those with financial responsibility in the charity sector to develop and adopt best practice. For more information go to [www.cfdg.org.uk](http://www.cfdg.org.uk)

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