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Pro-Active Legal Audits: What They Are and How to Use Them

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OVERVIEW OF PRESENTATION

• What Is a Pro-active Legal Audit?
• What Are the Stages of a Pro-active Legal Audit?
• What Is the Scope of a Pro-active Legal Audit?
• Additional Resources Available

A. WHAT IS A PRO-ACTIVE LEGAL AUDIT?
What Does a Pro-active Legal Audit Involve?
• “Being pro-active is always better than being reactive!”
• A pro-active legal audit is a lawyer-led review of a charity’s key documents and operations in order to ensure compliance with the law and help reduce the risk of liability for the charity and its directors and officers
• A pro-active legal audit is an essential process that assists the Board in fulfilling its fiduciary obligation to evaluate the charity’s compliance with its governance and operational documents, as well as the law in general
• A pro-active legal audit also facilitates the development of policies and procedures that will assist the charity in managing risks effectively in the future

• However, a pro-active legal audit cannot identify all compliance deficiencies, nor all legal risks that a charity may encounter

• A pro-active legal audit generally involves the lawyer reviewing the following:
  – Corporate documents, structure and compliance (i.e. letters patent and by-laws)
  – Inventory of property (i.e. land and buildings, leases and intellectual property)
  – Fundraising and financial matters (i.e. fundraising documentation, financial statements and investment policies)
  – Charitable issues (i.e. maintaining charitable status, Canada Revenue Agency (“CRA”) and Income Tax Act (“ITA”) compliance requirements)
  – Operational and risk management issues (i.e. due diligence policies, risk management procedures and insurance)

What Are the Reasons for a Pro-active Legal Audit?

• Charities, as well as not-for-profits collectively make up an essential part of Canadian society and its economy

• Charities and not-for-profits constitute the “Third Sector” of the economic engine of Canada

• Charities are facing fundamental changes and challenges in delivering their services to the public, in part because of a more litigious society
In facing these challenges charities must now become familiar with a vast array of legal requirements in numerous areas of law.

In order for charities to avoid exposure to legal liability, it is essential that they exercise due diligence in ensuring that they are in compliance with the legal obligations that are imposed upon them.

Why do charities often experience difficulties in complying with legal requirements?
- Complicated corporate and charitable requirements at both the federal and provincial level
- Increasingly complicated tax issues
- Expanding fundraising requirements
- Due diligence needed in the management of gifts and charitable receipting
- Inherent risks in operations, such as sexual abuse of children
- Determining appropriate investment policies involving charitable funds
- Incomplete corporate records
- Interrelationships between multiple corporate structures
- Privacy issues involving donors, employees and volunteers
- Compliance requirements under anti-terrorism legislation
- Frequently inadequate contractual documents

Possible consequences from legal non-compliance and deficiencies in organizational structure and operations:
- Revocation of charitable status
- Undertaking *ultra vires* activities
- Allegations of breach of trust
- Inquiries by the public under the *Charities Accounting Act* (Ontario)
- Legal actions by donors and/or the Public Guardian and Trustee (Ontario) (“PGT”)
- Court supervised audit of accounts
- Confusion in corporate operations
- Loss of corporate status
What Are the Benefits of Conducting a Pro-active Legal Audit?

- It allows the charity to identify areas of potential concern and possible legal risk ahead of time, thereby reducing the chance of legal actions.
- It identifies mandatory compliance matters, as well as recommended best practice standards.
- It assists the charity in prioritizing legal issues to be addressed by the charity, as well as setting out realistic time lines for the work to be done.

- It is an educational process that explains to the charity the nature of the legal work that is required in order to address issues of concern.
- It assists the charity by explaining the documents and practices of the charity that need to be amended in order to reflect changes in the law.
- It demonstrates due diligence by the charity’s board and senior management and thereby reduces their exposure to liability.

- The lawyer conducting the pro-active legal audit will provide the following benefits to the charity:
  - Explain the process of the legal audit to the charity.
  - Warn the charity of applicable risks and the consequences of intended courses of action.
  - Advise the charity if there are better alternatives available to its current practices and procedures in order to minimize those risks.
  - Produce a written report of the audit, which will be an essential historical reference document for future directors and future senior management.
B. WHAT ARE THE STAGES OF A PROACTIVE LEGAL AUDIT?

Preliminary Matters

• Selecting the lawyer
  – Experience in conducting a legal audit?
  – Breadth of knowledge in order to identify legal issues?
  – Ability to follow through and remedy deficiencies identified?

• Retaining the lawyer
  – What is the scope of the legal audit?
  – Is the audit to be completed in stages?
  – Are there specific exclusions to the audit?

• Equip the lawyer by providing the following:
  – An overview history of the charity and its relationship to other organizations
  – A full description of all programs and activities, together with full details on staff and volunteer requirements
  – Corporate records, i.e. letters patent supplementary letters patent, bylaws, minute books and various registers

  – Extra-provincial and fundraising registrations
    – Business name registrations
    – Trade-marks, official marks, copyrights and domain names
    – Deeds, leases and mortgages
    – Details of investments, as well as investment management agreements
    – Fundraising documentation, such as a gift acceptance policy, fundraising brochures, sample charitable receipts
    – Financial statements for the last three years, along with audit reports and management letters, if applicable
    – T3010’s (annual returns) for the last three years, and disbursement quota work sheets
Operational policies
Risk management documentation
Employee and volunteer documentation
Significant agreements that the charity is a party to, i.e. funding agreements, trademark or copyright licenses, agency and/or contracts for service agreements, and bilateral and multilateral international agreements
Copies of all insurance policies and reports from the insurance broker
Details of current compliance with CRA requirements for a registered charity, such as disbursement quota, political activities, related business activities, etc.

Undertaking the Audit
• The lawyer will generally need to undertake the following steps in conducting a pro-active legal audit
  – Review the documents provided by the charity
  – Conduct public record searches
    • Corporate profile and micro-fiche
    • Business name registration search
    • CRA online and private record search
    • Extra-provincial registration search
    • Trademark and domain name search
  – Review the charity’s website

– Interview senior management and/or board representatives as necessary and, where possible, arrange an onsite visit at the charity

• The lawyer should provide a verbal interim update of the audit in order to discuss and clarify issues with the charity

Reporting On the Audit
• The written report may be in either a preliminary or final form
• Preliminary form anticipates that further information and input from the charity may be forthcoming
• The report needs to explain the relevant law to their charity in order for the charity to avoid problems in the future
• The report needs to explain the consequences of identified deficiencies and the alternatives that are available
• The report should provide a prioritization of action items to be undertaken, and where possible, a time frame of when the action items should be completed
• The report should explain that the board of a charity has a fiduciary obligation to protect the charitable property and maintain the charitable status of the charity
• As such, the report should explain that the onus to respond to the report and take action as necessary lies with the board of the charity, not the lawyer

• A draft of the report should be sent to the charity for review by its main contact person before the report is signed and issued for distribution
• The audit report must then be distributed to all board members and senior management
• However, because the report may contain commentary on areas where the charity and the board may be exposed to liability, it is essential that the report be kept strictly private and confidential and that it not be copied to anyone else without the consent of the board
• Otherwise, the solicitor/client privilege for the report may be lost

• In the event that the report identifies significant areas of liability, then the report may need to recommend that board members and senior management obtain independent legal advice
• While there is no one format for an audit report, a pro-active legal report will generally include the following:
  – Scope and limitations of legal audit
  – Confidentiality
  – Executive Summary
  – Background facts
  – Substantive commentary on the issues
  – Prioritization and next steps forward
Follow-up Matters

- Meeting with the board and senior management to discuss the results of the audit and being able to ask questions of the lawyer
- The board needs to agree upon a timetable to implement any corrective steps that need to be taken
- Need to distinguish between time sensitive matters involving deficiencies in basic compliance matters and matters that are of a less pressing nature concerning best practice recommendations
- The charity should consider forming a legal risk management committee to oversee the implementation of the recommendations

- Depending upon the severity of any non-compliance issues identified, it may be advisable to proceed with a no-name disclosure
  - To the CRA for matters under the ITA to avoid either sanctions (i.e. penalties or suspensions) or even loss of charitable status in the event of a CRA audit
  - To the PGT in Ontario or Attorney General’s Office in other provinces for serious matters involving charitable property, such as unintended breach of trust involving restricted gifts, before a complaint is made

- It is important that all future board members be given a copy of the legal audit as soon as they come on to the board. The same practice should also be undertaken where there are additions to senior management
- The greatest risk of doing a pro-active legal audit is that the audit results and recommendations will not be acted on. This is the responsibility of the board and senior management of the charity, not the lawyer
- Therefore, if the board is not prepared to implement recommendations that the legal audit may result in, then there is no point in doing a legal audit in the first place
C. WHAT IS THE SCOPE OF A PRO-ACTIVE LEGAL AUDIT?

General Comments

• The scope of a pro-active legal audit will vary from charity to charity depending upon the nature of the operations of a charity

• For a broad survey of the types of topics that can be included in a pro-active legal audit, reference can be made to “Legal Risk Management Checklist for Charities” available at http://www.carters.ca/pub/checklists/charity.pdf

• What follows is a brief sampling of only a few of the issues and questions that will often be covered in a pro-active legal risk management audit

Organizational and Structural Issues

1. The Need to Identify and Compare the Different Types of Legal Forms for a Charity
   • Unincorporated associations
   • Trusts
   • Not-for-Profit Corporations
   • Charitable corporations

2. Organizational and Legal Documentation
   • Review of key documents for an unincorporated association
     – Are the objects clearly stated in the constitution and are they not-for-profit in nature or are they charitable in nature?
     – Do constitutional documents correctly reflect how the charity is actually structured and operated?
   • Review of key documents for an incorporated charity
     – Review of letters patent for issues such as
       • Are its objects exclusively charitable in nature?
       • Are the activities of the charity authorized by its corporate objects?
     – Review of supplementary letters patent (SLP)
       • Has there been a change of corporate objects or names?
       • Does the charity have historical records of all the by-laws of the charity?
– Need to review the current corporate by-law for basic terms, such as
  • Do provisions conflict with letters patent concerning objects or dissolution?
  • Do the provisions reflect the actual organization and operational structure of the charity?
– Have necessary corporate filings and registrations been kept up to date?
  • Ontario Corporations
  • Federal Corporations
  • Does the charity operate and/or fundraise in any other provinces?

3. Utilizing Multiple Corporations
   • Should the charity consider using multiple corporations for its high risk activities in order to reduce liability exposure and protect assets?

4. National/International Relationships
   • Are relationships with national organizations and/or subsidiary chapters adequately documented to protect the rights of both parties?
   • Are relationships between national and international structures adequately documented with specific reference to controlling trademarks in Canada?

• Has the ownership of the trade-marks and/or copyrights been determined and protected in Canada?

Board Governance and Liability Issues
1. Board Management Issues
   • Is the charity able to identify who is in charge of the organization?
   • Are there clearly defined lines of authority between the board and the executive staff?
   • Has a risk management committee of the board been established?
2. Reducing Board Liability
   • Do any directors of a charity receive direct or indirect remuneration?
   • Has the organization adequately indemnified its directors and officers?
   • Should the charity consider reducing the size of the board?
   • Is the charity effectively making use of committees?

Property Issues
1. Real Property Issues
   • Deeded land
   • Leased land

2. Intellectual Property Issues
   • Trade-marks
   • Copyrights
   • Domain names

Fundraising and Financial Issues
1. General Fundraising Issues
   • Are fundraising and/or administrative costs kept within the 80/20 disbursement quota?
   • Have fundraising programmes been reviewed by legal counsel?
   • Is the charity complying with applicable provincial statutory provisions pertaining to fundraising?

2. Donor Restricted Trust Fund Issues
   • Are there donor restricted trust funds being held by the charitable organization?
   • Are restricted funds used only in accordance with applicable restrictions?

3. Investment Issues
   • What investment powers apply to investment of surplus funds of the charity?
   • Does the charity need and/or have an investment policy?
### Charitable Status

1. **Maintaining Charitable Registration**
   - Does the charity submit its annual charity information return (form T3010) on a timely basis?
   - Is the charity and its directors aware of the recent key amendment to the *Income Tax Act* in May 2005 concerning the disbursement quota?
   - Is the charity and its directors aware of the key amendments proposed to the *Income Tax Act* from December 2002 to November 2006 on split receipting, anti-tax shelters and definition of private foundations?
   - Is the charity aware of the new rules that apply to Private Foundations that were proposed in the March 2007 Budget?

2. **Anti-Terrorism and Money Laundering**
   - Is the charity involved in political activities?
   - Is the charity involved in business activities?
   - Are agency, joint venture relationships or contractual transfer arrangements with non-qualified donees properly documented?

3. **Operational and Risk Management Issues**
   1. **Operational Policies**
      - Has the charity developed and implemented operational policies?
   2. **Employment and Volunteer Issues**
      - Has the charity developed appropriate policies and practices for hiring, disciplining and terminating employees and volunteers?
   3. **Third Party Use of Facilities**
      - Has the charity been made aware of potential liability exposure in permitting third parties to use its property?
      - Has the charity developed and implemented a third party facility use agreement with appropriate releases and indemnification?
4. Insurance Considerations
   • Has the charity provided full written
disclosure on a regular basis of all risks to its
insurer to avoid denial of coverage?
   • Does the charity require regular reports from
its insurance broker on existing coverage,
exclusions from coverage and
recommendations to enhance coverage?
   • Is there a regular review of the adequacy and
extent of general liability coverage and
property insurance?

D. ADDITIONAL RESOURCES AVAILABLE
   • Note: For more details generally see articles and
newsletters at www.charitylaw.ca
   • Note: Several articles and powerpoints that deal
specifically with issues that were addressed
today include, but are not limited, to the
following:
     – “Pro-Active Legal Audits: What They Are
and How to Benefit from One”
     – “Legal Risk Management Checklist for
Charities” http://www.carters.ca/pub/checklist/charity.pdf
     – “The Legal Duties of Directors of Charities
and Not-for-Profits”
     – “Due Diligence in Avoiding Risks for
Directors of Charities and Not-for-Profits”
       available at the following internet address:
     – “Looking a Gift Horse in the Mouth: Legal
Liabilities in Fundraising” available at the
following internet address:
     – “Donor-Restricted Charitable Gifts: A
Practical Overview Revisited II” available at
the following internet address:
“Essentials of Operational Risk Management” available at the following internet address:

“New Anti-Terrorist Financing Law has Direct Impact for Charities”

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