

INTERNATIONAL CORPORATE LAW  
AND FINANCIAL MARKET REGULATIONS

Comparative  
Corporate Governance  
of Non-Profit  
Organizations

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KLAUS J- HOPT AND  
THOMAS VON HIPPEL

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# Good and not so good governance of nonprofit organizations: factual observations of foundations in Germany

CHRISTOPH MECKING, BERLIN\*

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## I Introduction

One core area of the nonprofit sector in Germany is the German foundation system.<sup>1</sup> The incorporated foundation, which is regulated in Sections 80-88 of the German Civil Code (BGB), is considered the prototype and legislative model for foundations. This type of foundation accomplishes its charitable purpose only by grant-making.<sup>2</sup> In addition, there is a great number of foundations lacking legal capacity, substitute types such as the foundation company and foundation association, as well as public foundations.<sup>3</sup>

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\* Translated by Dr. Geoffrey S. Koby, Kent State University

<sup>1</sup> Cf. Zimmer, A. 2005. "Stiftungen als Organisationen der Zivilgesellschaft" ["Foundations as Organizations in Civil Society"], in: *Stiftungen in Theorie, Recht und Praxis [Foundations in Theory, Law, and Practice]*, p. 9 ff.

<sup>2</sup> A discussion of the development of the modern foundation model in Germany from a comparative legal perspective can be found in Richter, A. 2001. *Rechtsfähige Stiftung und Charitable Corporation [Foundations with Legal Personality and Charitable Corporations]*, p. 40 ff.

<sup>3</sup> Mecking, C. 2005. "Stiftungslandschaft in Deutschland" ["The Foundation Situation in Germany"], *Stiftung&Sponsoring Rote Seiten (S&S RS) [Foundation & Sponsoring Red Pages]* 2/2005, p. 3 ff.

The foundation sector has been growing constantly, with particularly dynamic growth rates starting more than ten years ago.<sup>4</sup> At the beginning of 2007, 14,401 incorporated foundations with legal personality were known to exist in Germany,<sup>5</sup> while in 1995, only half that number existed (7,095). 889 of these foundations were newly founded in 2006.<sup>6</sup> Although the oldest German foundations are probably more than a thousand years old, the majority represents quite a young and varied group of institutions whose contours and self-concept are still developing and undergoing a process of change which has been both promoted by the modernizing legislation of the past several years and frustrated by attempts to liberalize regulations. “Foundation governance”<sup>7</sup> as an instrument for self-regulation and self-validation is the subject of increasing discussion in the industry, which must also be seen in the context of these trends.

Foundations are customarily defined in brief as a long-term special-purpose fund that has become independent – as no legal definition exists. This concept is linked to the idea of a type of organization that is set up for the long term in which there are sufficient assets to achieve specific purposes that usually serve the public good, independently of a foundation’s specific legal form. Foundations represent an organizational connection between money and an idea. In its ideal form, a foundation is characterized by the following three features: Purpose, assets, and a separate organization<sup>8</sup> that is required to consist of a board of directors. Foundations are linked to various special features that are also the reason why foundations are attractive: their permanence, the authority of the founder’s intent, and their autonomy with its related independence from owner interests.

Upon its establishment through a private foundation transaction and its recognition by the government as having legal personality, a foundation is fundamentally released into an irreversible autonomy that is uninfluenced by shareholders or members. Since a foundation is fundamentally lacking owner interests and corresponding internal monitoring bodies (other than in the case of an association or a company with their interested members or shareholders), since a foundation represents “defenseless assets lying there tempting greed” – to use the words of the legal historian Hans Liermann,<sup>9</sup> this legal form is also particularly informative on issues of corporate governance due to its internal structure.

Although John A. Edie reports a different situation in the U.S.,<sup>10</sup> in Germany the media have only discovered foundations more recently, after taking no notice whatsoever of them for a long period. However, their reporting is positive, almost without exception, which is likewise different than in the U.S.<sup>11</sup> They call attention to the accomplishments of the foundations for the public good, celebrate generous founders and donors, and explain the advantages that go along with the establishment of a foundation. It is striking that criticism is articulated with relative restraint and even then expressed in a more general way. For

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<sup>4</sup> Ibid. and Mecking, C., 2001. “Zur Situation der Stiftungen in Deutschland” [“The situation of foundations in Germany”] in K.J. Hopt & D. Reuter, eds., *Stiftungsrecht in Europa [Foundation Law in Europe]*, p. 33 ff.

<sup>5</sup> www.stiftungsstatistik.de.

<sup>6</sup> www.stiftungsstatistik.de.

<sup>7</sup> Cf. Zurkinder-Erismann, L., 2006. “Foundation Governance,” *S&S RS* 1/2006.

<sup>8</sup> See Rawert, P., “Der Stiftungsbegriff und seine Merkmale” [“The concept of a foundation and its features”] in K.J. Hopt & D. Reuter, eds., *Stiftungsrecht in Europa [Foundation Law in Europe]*, p. 109 ff.

<sup>9</sup> Liermann, H. 1963. *Geschichte des Stiftungsrechts [History of Foundation Law]* (2nd edition 2002, A. von Campenhausen & C. Mecking, eds.)

<sup>10</sup> See the article by J.A. Edie in this volume.

<sup>11</sup> Strachwitz, R. 2006. “Die Stiftung im Bewusstsein der deutschen Öffentlichkeit” [“The foundation in the consciousness of the German public”], in: P. Egger, B. Helmig, and R. Putschert, eds., *Stiftung und Gesellschaft [Foundation and Society]* p. 133: “hardly any critical voices.”

example, a comment might be made that the decision-making bodies are not legitimate from a democratic perspective, or that the activities of the foundations are not sufficiently transparent. What is lacking to a great extent is the exposure and description of cases of abuse such as those reported by John A. Edie in the U.S. The only case that was widely discussed publicly and also caused a stir beyond the foundation scene itself occurred nine years ago (Hertie Foundation, for details see II A below), precisely at the time when the German legislature was intensively discussing a reform of the legal and tax framework for the foundation system.

The political discussion and steps toward implementing the foundation system reform in Germany started in 1996 and are still continuing, although public attention has declined greatly. The debate, which cut across party lines, was guided by the goal of improving the structural conditions for founders and foundations. The context of this initiative was and is the declining financial capability and creative power of the state and its institutions, as well as the desire of the legislature to motivate wealthy people to become involved in civic affairs, to voluntarily make portions of their wealth available for charitable purposes and to commit them for the long term, and ultimately to achieve effects that would relieve the burden on the public budgets. The institution of the foundation seemed to be an appropriate object for this action because it has a special freedom in its design, enjoys a good reputation among the public, and provides the founder with an opportunity to perpetuate his or her own will and name, or stands for the idea of establishing an “ideal heir” if no relatives are available to inherit. At the German federal level, the reform efforts achieved an initial result in the Tax Relief for Foundations Act<sup>12</sup> and the Modernization of Foundation Law Act of 7/15/2002,<sup>13</sup> which entered into force on 9/1/2002. The harmonization of foundation laws at the *Land* (state) level to the legal situation at the German federal level is still ongoing.<sup>14</sup> Efforts are currently ongoing for further improvements in charitable tax law.<sup>15</sup>

## II Not so good foundation governance

### A Problem cases

In Germany, there are very few cases in which foundations are topicalized in the media as the object or subject of abuse. However, the Hertie Foundation case attracted special attention.

*The Hertie Foundation Case.* At the end of May 1999, a three-page article appeared in Germany’s most important news magazine, *Der Spiegel*, under the title “Steuertricks der Hertie-Erben” [“Tax Tricks of the Hertie Heirs”].<sup>16</sup> This article raised serious accusations against the Hertie foundation, headquartered in Frankfurt/Main, which was part of a variation

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<sup>12</sup> The *Gesetz zur weiteren steuerlichen Förderung von Stiftungen* of 7/14/2000 (German Federal Law Gazette (BGBl.) I p. 1034).

<sup>13</sup> The *Gesetz zur Modernisierung des Stiftungsrechts* of 7/15/2002 (German Federal Law Gazette (BGBl.) I p. 2634).

<sup>14</sup> Cf. Richter, A. and S. Sturm, 2005. “Das neue Stiftungsrecht in Bund und Ländern” [“The new foundation law at the German federal and provincial levels”], *S&S RS 4/2005*; Mecking C., 2006. *StiftG Rheinland-Pfalz [The Rhineland-Palatinate Foundation Act]*, p. 26 ff.

<sup>15</sup> Cf. the government draft of an act for the further strengthening of civil involvement of 2/14/2007; Steinbrück P. and C. Mecking, “Das verdient jede Anerkennung” [“This deserves recognition”], *S&S 1/2007*, p. 6 ff.

<sup>16</sup> Heise, T., F. Kurz, and H. Schumann, “Steuertricks der Hertie-Erben,” in *Der Spiegel* 22 dated 5/31/1999, p. 76 ff.

of the popular double foundation model that is used to create succession solutions in companies.<sup>17</sup> A fired foundation employee had apparently disclosed internal documents before leaving.

A major part of the assets belonging to Georg Karg, the department store magnate who passed away in 1972, had been transferred to the Gemeinnützige Hertie-Stiftung zur Förderung von Wissenschaft, Erziehung, Volks- und Berufsbildung (Charitable Hertie Foundation for the Promotion of Science, Education, Popular and Professional Training), which was among the largest foundations in Germany, measured by its endowment (12/31/2005: €817 million). The Charitable Hertie Foundation was the holder of 97.5% of the shares in the company Hertie Waren- und Kaufhaus GmbH, and about 6% of the voting rights. The taxable Hertie Family Foundation, which had been established as early as 1953, held 0.5% of the shares and 75.1% of the voting rights, and was thus the controlling shareholder. Some of the persons constituting the decision-making bodies were the same at both foundations. In November 1993, the charitable foundation sold the Hertie corporate group to Karstadt AG tax-free for over €800 million. This foundation then passed on the purchase price to the family foundation as what is called a “loan with profit participation” with interest based on profits. The family foundation then acquired 30% of the shares in Karstadt from two banks, thus becoming the principal shareholder of Karstadt AG. The charitable foundation was to be entitled to 37.5% of all profits from the management of the financial assets by its sister foundation. The magazine alleged that this profit was kept as low as possible using tricks and expenses for the benefit of the family members and officers. While the family foundation was said to have received dividends of about €25 million, only about €4 million had gone to the charitable foundation. The achieved rate of return of 0.5% was thus alleged to be less than investing the money in a savings account. The high point of this “re-privatization,” according to the magazine, was reached in summer 1998, when the share package was sold to the Schickedanz commercial group with its “Quelle” mail-order house, without the loan being returned to the charitable foundation. Instead, it was alleged to have remained at the minimum interest rate.

The management of the Hertie Foundation attempted to refute the accusations by argumentation, particularly by making reference to the economic advantages of the loan agreement with profit participation for the charitable Hertie Foundation,<sup>18</sup> to a reorganization that was to occur immediately, and to their ongoing consultation with the competent government tax and foundation authorities.<sup>19</sup> At this writing, the restructuring has occurred; the foundations have been renamed and separated. The preliminary investigations by the public prosecutor and the tax investigation service ended without a published result. Today, the Charitable Hertie Foundation is among the largest German foundations, also when measured by the grant funds available to it, and currently grants about €25 million for its innovative charitable model projects in medical research and in education.<sup>20</sup>

Enough on the Hertie Foundation case, which at the time severely disrupted the debate on legal improvements in the foundation system, but which ultimately did not diminish the results aimed, at motivating founders and making foundation work easier. There is a lack of

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<sup>17</sup> Specifics in Rehmann, K., 1999. *Hertie-Stiftungen: Bewahrung eines großen Vermögens [Hertie Foundations: Preservation of a Major Fortune]*, p. 1.

<sup>18</sup> Rehmann, K., 1999. *Hertie-Stiftungen: Bewahrung eines großen Vermögens [Hertie Foundations: Preservation of a Major Fortune]*, p. 7; Rehmann, K., 1999. “Antworten an den SPIEGEL” [“Replies to *Der Spiegel*”] p. 3 ff.

<sup>19</sup> Rehmann, K., 1999. *Hertie-Stiftungen: Bewahrung eines großen Vermögens [Hertie Foundations: Preservation of a Major Fortune]*, p. 10.

<sup>20</sup> [www.ghst.de](http://www.ghst.de).

reporting in the media on other problematic cases from the German foundation system. However, a few examples will show that there are certainly cases that are at least problematic from a governance point of view. These examples were not discussed extensively in the public arena, and they occurred or could have occurred in this way or in other ways, and can therefore only be discussed anonymously.

*The Luxurious Board Meeting.* According to its articles of incorporation, a scientific foundation “A” supports research institutions that are located in various countries. Representatives of these institutions are members of the nine-person foundation board. Once a year, there is a board meeting, for which the foundation reserves blocks of rooms in a five-star hotel. A member of the board, traveling with his spouse from overseas, resides in a suite in the most expensive hotel in the city, whose price is twice as expensive as those of his colleagues. He booked his flight in first class with multiple intermediate stops which are not itemized in the full settlement of the travel expenses submitted to the foundation. Because this person is a close friend of the founder, and although he is the representative of one of the supported institutions, the invoices are paid without question.<sup>21</sup>

*The Additional €150,000 Salary.* In their joint will and testament, a married couple had named the “B” foundation as their sole heir and appointed four executors, including the minister-president of German *Land* (state) B in office at any given time. The remuneration of the minister-president amounted to €150,000 annually, which he collected in addition to his official salary.

*The Emeritus Case.* An emeritus professor is the sole executive board member of a scientific foundation “C” that does not provide for any other corporate bodies. Contrary to the broadly conceived grant activity originally intended by the founder, he grants the foundation funds exclusively to his former students and scientific colleagues, because “he knows their accomplishments and quality the best.” Calls for proposals are “deliberately” not carried out “in order to save on expenses.”

*Private Benefits to the Chairman.* Given his advanced age and health problems, the founder and chairman of the executive board of an educational foundation “D” passes his office on to a successor identified through a job advertisement. This person succeeds in persuading personal friends to become involved in the foundation bodies. A few weeks after the death of the founder, the new chairman of the board settles private invoices from the foundation account and has advances disbursed to him for travel expenses, which he then does not settle. Half of the “D” foundation’s entire annual budget is used up in this way. The chairperson of the board of trustees, who has been in office for many years, is unsuccessful in resolving the matter once it becomes known internally, due to the new majority. She turns to the competent foundation supervisory agency and requests a formal investigation. The head of the agency knows the chairman of the board well and refuses to take action. Although she is recalled from the board of trustees and warned by the board of directors, she does not drop the issue. At this point, the tax authorities and public prosecutors are investigating.

*The Secret Salary.* After the death of the founder, who was the sole executive board member of a social foundation “E” on a volunteer basis, his successor submits an unsigned “Rules of Procedure for the Executive Board and Board of Trustees” with an older date to the board of trustees. This document was unknown to any member of the board of trustees at that time. This document, whose authenticity is justifiably doubtful, states that reimbursements for expenses shall be decided on solely by the executive board. On this basis, he grants himself a

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<sup>21</sup> Cf. the critical remarks on luxurious trips by foundation bodies of the U.S. W.K. Kellogg Foundation in Latour, F. and S. Pfeiffer, “At some foundations first-class perks,” *International Herald Tribune* dated 4/20/2004, p. 2.

monthly expense allowance of €2,000 as executive board member. The budget of the foundation is about €50,000, and the monthly amount of work is about four hours.

*The Land Exchange:* The “F” foundation, which was established in the 15<sup>th</sup> Century, is managed by a municipality that is planning the construction of a new street. For this purpose, it requires a plot of land in the downtown area that is owned by the foundation. In order to save funds, the municipality does not buy the real estate at its current market value of €300 per square meter. Instead, it arranges a decision stating that the plot will be exchanged for another area of identical size that is owned by the municipality. The exchanged plot of land is located in a nature preserve; no current market value can be determined for it.

*Selection Criteria for Beneficiaries.* On the occasion of its 50<sup>th</sup> anniversary, Bank “G” establishes the charitable “G” sports foundation with a smaller endowment; its activities are financed by donations from the bank. The management of the foundation takes place in the offices of the secretary to the executive board. Multiple small grants are given to sports associations in the region. Grants only go to those associations that are bank customers or are recommended by the mayor, who is the chairman of the bank’s board of directors. The checks for grants are delivered by the bank’s branch managers with media attention.

*The Birthday Party.* On his milestone birthday, the “H” foundation gives the responsible chairman of the executive board a birthday party – on his instructions – to which several hundred guests are invited. The costs are paid by the foundation, which was only founded a few years previously after the death of the founder.

*Distribution and Use of Income.* At the “I” foundation, one-third of the net proceeds from investments of financial assets are retained in order to preserve potential and compensate for inflation (Section 58 (7) of the Tax Code (AO)); another third is used for the “appropriate support” of the closest relatives of the founder (Section 58 (5) AO). On the one hand, the final third that is available for grants pays the remuneration of the managing director, the son of the founder, and on the other hand, it supports projects in development aid for the South Pacific area. The selection is made by the board of trustees, which is staffed solely by family members of the founder, on longer trips to those locations.

These examples highlight some facts that are relevant under foundation law, and sometimes even under criminal law, and ought to be punished as fraud or breach of trust. Others are problematic from the perspective of charitable tax law, because the precept of unselfishness (Section 55 AO) applies here in particular. According to this precept, unselfish action always exists when a corporate body does not primarily have its own economic purposes as its goal. On the other hand, support of the economic interests of the members of its corporate bodies and its founder are detrimental. And there are additional cases that lack legal relevance, but are morally questionable or do not satisfy quality requirements.

## *B A lack of publicity*

There are many reasons why cases of abuse in the foundation system are not publicized, or only insufficiently. For instance, the legal framework in foundation law is comparatively broad. There is additional permitted leeway particularly for the design of long-term preservation of an estate or for use in corporate contexts.<sup>22</sup> There are only a few truly large foundations where cases of abuse reach a dimension that is also financially relevant and attracts public attention. The foundations and their representatives themselves are discreet as to their own affairs. They are particularly reluctant to provide information on financial

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<sup>22</sup> Extensive information can be found in Schlüter, A., 2004. *Stiftungsrecht zwischen Privatautonomie und Gemeinwohlbindung [Foundation Law Between Private Autonomy and Obligations to the Public Interest]*, particularly p. 185 ff.

matters. This reserve is also intended to minimize greed and expectations or a feared flood of applications, which the foundations cannot or do not want to grant. Publicity and transparency are only established on a voluntary basis and only to a degree that is individually selected. There is thus also a lack of comparability and opportunities for research. The newly implemented foundation registries only provide some basic information, such as the name, the purpose, or the year of establishment. Some foundations, particularly also older ones, are situated in proximity to public service and have anticipated their behavioral codes with regard to travel expenses or remuneration issues, for instance, without examining them and adjusting them to the situation of the foundation. There is a double check by the foundation supervisory agency and the tax authorities, but it remains in the confidential space. Tax secrecy applies.

### **III Good foundation governance**

#### *A Government monitoring*

Despite the concept of foundational autonomy, the foundation is a system dependent on its environment with many reciprocal relationships within the foundation (internal bodies and offices) as well as between the foundation and outside third parties.<sup>23</sup> Good foundation governance, that is, responsible and effective foundation management, must start with these exchange and relationship processes. The important ones are the relationship of the foundation to the founder, the internal processes within the foundation, and the relationships between the foundation and outside third parties.

It goes without saying that good governance always means compliance with the regulations of German federal and state law as well as the internal regulations of the foundation set forth in the articles of incorporation. Since foundations are lacking internal monitoring bodies, the legislature has provided for an external monitor.

Incorporated foundations with legal personality are subject to the foundation supervisory agency according to the provisions of their individual German state law.<sup>24</sup> The foundation supervisory agency is designed solely as a supervisory agency for legal matters, and is intended to ensure that the managing directors of the foundation act in a legal manner – particularly after the death of the founder. Therefore, the foundation supervisory agency is supposed to be a government substitute for the lack of internal monitoring, and, furthermore, a guarantor of the founder's will. It acts not only in the public interest in protecting legal dealings from illegal actions of the foundation bodies, but also in the interest of the founders and foundations themselves.

Since the end of 2002, the German state foundation laws have been adapted to the changed German federal regulations and newly adopted, in most states. The supervisory instruments have also been revised and the frequency of checks reduced, in accordance with the legislative goal of strengthening the responsibility of the foundation bodies. Despite all of the differences in detail, the following elements of foundation supervision can be stated:

- The bases for ongoing monitoring by the foundation supervisory agency are the yearly statements of account, including an overview of assets and a report on carrying out the purposes of the foundation that the foundations must submit annually to the supervisory agencies. To the extent that these documents have already been audited by external

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<sup>23</sup> On the legal relationships between foundations and “those participating in foundations,” see Jakob, D., 2006. *Schutz der Stiftung [Protection of the Foundation]*, p. 103 ff.

<sup>24</sup> A comprehensive discussion is in Andrick, B., and J. Suerbaum, 2001. *Stiftung und Aufsicht [Foundation and Supervision]*.

offices (independent auditors or accountants), it is frequently provided that no further monitoring will occur, in order to ease the administrative burden. The foundation supervisory agency is expected to act officially when it discovers supposed or obvious violations of law by the foundation bodies.

- If the foundation supervisory agency must act, it has extensive authority to intervene, ranging from information rights (information, submission of documents, examination, and audit), through the authority to issue orders (objections, repeal of resolutions, compensatory performance), up to removal and appointment of members of bodies, appointment of a custodian, or assertion of claims for damages against members of bodies.
- The foundation supervisory agency must receive notice of or approve a small number of legal transactions that are generally particularly significant for the existence of a foundation, and amendments to the foundation's articles of incorporation. However, such notification and approval reservations have been significantly reduced in the revision of the German state laws.

Opinions vary on the value of foundation supervision in practice. Some writers question its ability to function and highlight insufficient personnel, political influence, and a lack of competence and ability to assert itself. Others attribute monitoring deficits to the sphere of responsibilities of the foundation bodies, which can be determined and understood only with difficulty.<sup>25</sup>

In addition to this external monitoring of foundations by the foundation supervisory agency, the tax authorities also have monitoring authority. During the annual assessment or during external audits, the tax offices audit whether the foundations have satisfied the legal requirements for claiming tax benefits due to their charitable nature. The foundations must provide the necessary documentation, while the tax office normally limits itself to simple checking of the submitted documents or to external audits. For instance, what is audited is the charitable purpose as provided for in the articles of incorporation, that is, the correspondence of the articles of incorporation with the legal requirements, timely payment of sales and wage taxes, proper use of funds and creation of reserves, compliance with the requirements when issuing receipts for contributions that can be used by founders or supporters to deduct their contributions from their tax burden, or compliance with tax obligations that can arise from the operation of taxable economic enterprises or tax-privileged objective-related operations.

However, the foundation supervisory agency and the tax offices neither serve the same purposes, nor are they linked under procedural law. Therefore, there are frequently conflicts of assessment between foundation law and tax law, which in practice must be resolved by the foundation bodies. For instance, the tax offices hardly pay attention to whether the value or existence of the endowment has been preserved; instead, they want to ensure that the greatest possible amount of funds have been used in a timely fashion for the tax-privileged purposes. Contrariwise, the foundation supervisory agency is less interested in timely use of funds, but rather that, above all, the endowment has remained untouched. The resolution of this contradiction between the tax prohibition on retention of income and the precept of amassment under foundation law is one of the classics of foundation practice.

In the case of foundations that receive public funds, further monitoring offices are added, such as the ministry granting the subsidies and the competent audit office, which audit compliance with the requirements of public subsidy law and the grant conditions.

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<sup>25</sup> A recent assessment from a comparative legal perspective can be found in Selbig, S., 2006. *Förderung und Finanzkontrolle gemeinnütziger Organisationen in Großbritannien und Deutschland [Promotion and Financial Monitoring of Charitable Organizations in Great Britain and Germany]*, p. 293 ff.

## B Self-regulation

Since the end of the Nineties, the foundation sector has been discussing self-regulatory standards in order to counter the fear of critical interest in foundations that might be connected with the foundation boom, to counter the discovery of any cases of abuse, to separate itself from “black sheep,” and to prevent legislative action.<sup>26</sup> To the extent that additional codes of conduct are voluntarily created and complied with, good foundation governance extends beyond compliance with the legal regulations.

Prompted by the development of the “Code of Practice” at the European level, which was intended to create standards for the establishment of foundations in the newly emerging democracies of Central and Eastern Europe, the Bundesverband Deutscher Stiftungen, the umbrella organization for foundations in Germany, initiated a discussion of developing “foundation ethics” in Spring 1999. An issue of the association’s magazine was dedicated to this topic,<sup>27</sup> and a working group was established.<sup>28</sup> This debate was then further stimulated by the corporate governance debate in the commercial companies, which, boosted by cases of abuse in business and by the fight against terrorism, led to comprehensive regulatory and self-regulatory effects for publicly-held companies in the U.S. (the Sarbanes-Oxley Act) and in Europe (e.g., the German Corporate Governance Codex or the Control and Transparency in Business Act (KonTraG), for several years. After subsectors of the German foundation system – the community foundations in May 2006,<sup>29</sup> and the municipally managed foundations – had originally drafted some guidelines, it was then possible to adopt an initial position paper, the “Principles of Good Foundational Practice” (“Grundsätze Guter Stiftungspraxis”) in May 2006.<sup>30</sup> This paper contains very brief and noncommittal central topics about the persons acting and about avoiding conflicts of interest; initially, any threat of sanctions in case of noncompliance, such as loss of membership in the association, was avoided. Thus they do

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<sup>26</sup> Cf. “Geführt etwa” [“This is management?”] in the professional magazine *Stiftung&Sponsoring (S&S) [Foundations&Sponsoring]*; cf. Zurkinden-Erismann, L., 2006. “Foundation Governance,” *S&S Rote Seiten (RS) [S&S Red Pages]* 1/2006; Koch, C. and T. von Holt, 2005. “Überlegungen zur verantwortungsvollen Führung von Stiftungen” [“Considerations on the responsible management of foundations”], *S&S RS* 1/2005; Ruter, R.X. and M. Häfele, 2004. “Ein Corporate Governance Kodex für Stiftungen?” [“A corporate governance codex for foundations?”], *S&S* 5/2004, p. 5 ff.; Neuhoff, K. 2003. “Grundsätze ordnungsgemäßer Stiftungsverwaltung” [“Principles of generally accepted foundation management”], *S&S RS* 2/2003.

<sup>27</sup> *Deutsche Stiftungen: Mitteilungen des Bundesverbandes Deutscher Stiftungen (DS) [German Foundations: Bulletin of the Federal Association of German Foundations]* 1/1999, particularly p. 19 ff.: focus on “foundation ethics.”

<sup>28</sup> Mecking, C., 1999. “Fachausschuss ‘Stiftungsethik’ gegründet: Papier zur freiwilligen Selbstverpflichtung von Stiftungen” [“Technical committee for ‘foundation ethics’ founded: Paper on the voluntary obligation of foundations”], *DS* 1/1999, p. 7; von Campenhausen, A. 2000. “Deutsche Stiftungen: Vielfalt fördern!” [“German Foundations: Demand Diversity!”] in: Bundesverband Deutscher Stiftungen (ed.), Berlin, p. 357 f.; cf. also Brendel, G. and C. Mecking, 2002. “Vertrauen durch Transparenz: Ein ‘freiwilliges Selbstverpflichtungsprogramm’ für den Stiftungssektor” [“Trust through transparency: A ‘voluntary obligation program’ for the foundation sector”], *DS* 1/2002, p. 91 f.

<sup>29</sup> Mecking, C., 2005. “Das Gütesiegel für Bürgerstiftungen” [“The seal of approval for community foundations”], in: *Zeitschrift zum Stiftungswesen (ZSt) [Journal of the Foundation System]*, p. 48.

<sup>30</sup> Falk, H. 2005. “Leitlinien guter Stiftungspraxis” [“Guidelines for good foundation practice”], in: *DS* 4/2005, p. 35.

point out significant problematic situations, but they are too general and too broadly worded to truly provide an orientation.<sup>31</sup>

Good foundation governance such as this is intended to make the responsible persons involved more sensitive.<sup>32</sup> Its goal is to promote effective and transparent implementation within the foundation of the will of the founder as manifested in the purpose of the foundation. Its use is intended to promote an efficient organizational and management structure in order to help prevent abuses and avoid conflicts of interest, as well as to create trust in all of the stakeholders standing outside the foundation through transparency and predictability. It is intended to motivate foundations to reflect on and improve their activities and to offer a set of verification instruments and a frame of reference. Finally, it serves as an aid to interpretation for application of the law.

## *C Principles of good foundational practice*

### 1 General remarks

In an increasing number of foundations, the reserve once displayed on issues of responsible management is giving way to a receptiveness to dealing with the interest in and demands of the public on the activities of the foundations, and to accepting advice. The management bodies of foundations, as well as the representatives of their entitled groups (e.g., the foundation supervisory agency, independent auditors, and beneficiaries<sup>33</sup>) must deal with the issue of what standards exist and which ones will be declared binding in individual cases. The listed principles, which are at least formally supported by a broad majority of foundations, can be useful in a self-examination and amendment of the articles of incorporation or implementation of a governance audit. Such instruments are an expression of the responsibility that is linked to the freedoms of the modern foundation system.

A few key words can outline the possible content: founder's will, foundation purpose and model; granting principles; general management system; rules of committee work; investment of assets; financial budgeting; accounting and internal controlling; management; stakeholder interests; communication; cooperation; evaluation. Anything that has been specifically included in rules of procedure and guidelines can determine the measure of liability for any member of a foundation body who performs an action.<sup>34</sup> The liability requirements are also tightened to the degree that traditional notification and approval reservations of the government supervisory agencies disappear in favor of the responsibility of the foundation bodies. It is also possible to conceive of an amendment to the articles of incorporation, which the German state foundation laws now permit more easily than before, as long as they merely correspond to the manifest will of the founder. Some areas of conflict that should be considered in the context of such good foundation governance are discussed in depth below.

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<sup>31</sup> The "Swiss Foundation Code: Empfehlungen zur Gründung und Führung von Förderstiftungen" ["Recommendations for the establishment and management of granting foundations"], for instance, is more comprehensive; it is reprinted in K. Hofstetter and T. Sprecher (eds.), 2005. *Swiss Foundation Code*, p. 7 ff.

<sup>32</sup> Steuber, E., 2006. "Corporate Governance bei Stiftungen – eine Frage der Kontrolle oder der Moral?" ["Corporate governance at foundations – A question of monitoring or morality?"] *DSiR* p. 1182 ff.

<sup>33</sup> See also Thymm, N., 2007. *Das Kontrollproblem der Stiftung und die Rechtsstellung der Destinatäre [The Monitoring Problem of Foundations and the Legal Position of the Beneficiaries]*, particularly p. 143 ff., 297 ff.

<sup>34</sup> Schiffer, K.J., 2006. "Haftung und Corporate Governance bei Stiftungen" ["Liability and corporate governance in foundations"], *ZCG*, p. 3 ff.

## 2 Influence of the living founder

First, the influence of the living founder. The appropriate relationship between foundation and founder is a very controversial topic. First of all, the founder is the creator and designer of the foundation, who initially deserves special thanks, since after all it is he who accomplished the act of translating his foundational intent into intangible added value, into a set of articles of incorporation that is both individual and establishes identity as well as open to the future, and who dedicated his private fortune to the goals of the foundation. However, the foundation is fundamentally created independently from the founder. This is apparent, for instance, in the fact that after its creation by receipt of the government recognition certificate, the foundation has a claim against the founder for transfer of the promised assets, and can also enforce it in court. Nevertheless, during his life the founder still considers the foundation “his property.” That is understandable psychologically, but can lead to major conflicts with the bodies or even within the bodies of the foundation, if the founder has reserved this position to himself.

The issue of the influence of a living founder on “his” foundation becomes particularly apparent in what are called “company-related” foundations. If a company creates a corporate foundation, then it is frequently doing so for communications reasons; in a publicly-held company, this is obvious in the context of the shareholders’ interests. In this case, the will of the founder is no longer an expression of the will of a person; instead, it is based on the decisions made by officials who are expressing the interests of their company and want to keep them subject to the approval of their shareholders. Therefore, the company attempts to preserve its influence on the foundation, for instance by appointing representatives of the company to a majority on the foundation bodies, or by designing the funds necessary to finance the foundation’s activities as annual donations from the company. In this way, the management of the foundation easily falls into a conflict of loyalties, being required to decide between the interests of the founding company and an optimum implementation of the foundation goals as set forth in the articles of incorporation, if no reconciliation is possible.

This issue is even more starkly apparent when the government establishes foundations under private law.<sup>35</sup> By and large, the state as a founder does not provide for secured endowment with assets. Instead, what occur are ongoing donations in accordance with budgetary law and the individual budgets. This makes a policy of “golden reins,” which does not do justice to the expectations for a foundation.

If the founder does not want to or cannot completely let go, he can secure cooperation rights in the articles of association. For instance, he can be the sole managing director of the foundation or chairman of the board of trustees for life. He can retain veto rights for specific decisions, such as dissolution of the foundation or amendments to the articles of incorporation. In these cases, good foundation governance must mean establishing the interfaces unambiguously and at the same time respecting a core area of autonomous foundation action.<sup>36</sup>

## 3 Internal organization

Within a foundation, organizing the structure as well as the strategic and operational aspects of responsible management in an appropriate relationship to the purpose and the assets is an expression of good foundation governance. Here, management can be understood as the sum

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<sup>35</sup> Mecking, C. and M. Schulte (eds.), 2003. *Grenzen der Instrumentalisierung von Stiftungen [Limits on the Instrumentalization of Foundations]*.

<sup>36</sup> In *Schutz der Stiftung [Protection of the Foundation]*, 2006, p. 474 ff., D. Jakob assigns special significance to the design of the articles of incorporation by the founder in the prevention of conflicts.

of the various processes that are determined by the central duties of strategic management of the highest foundation body. Strategy is understood to mean the decisions on and design of the normative management instruments such as models (a mission statement) and plans. What is particularly important here is the interpretation of the foundation's purpose (taking into account the will of the founder) as well as the fundamental decision on organizational forms and plans, which are related to performance and resources.

In order to optimize the foundation's internal organizational structure, the important thing will be to find a structure for the functioning of the bodies and their members that is as conflict-free as possible. The required body for a foundation is the foundation executive board. Therefore, it has a strategic and operational task, as well as untransferable core competencies such as the power of representation. The articles of incorporation may provide for a supervisory body (board of trustees, foundation board, etc.). Such a second body is recommended, particularly for larger foundations, in order to ensure effective monitoring and advising of the executive board. This applies to the economic aspects of foundation work (principles of asset investment), to the selection of executive board members, and to the essential features of operational foundation activity such as grant-making goals, strategies, and guidelines. If such a supervisory body exists, the strategic tasks must be unambiguously assigned or divided in a logical way. The important thing is precise jurisdictional rules. The development of rules of procedure is recommended, in which the executive board and the supervisory body adopt more specific regulations on their cooperation, such as on calling meetings or voting procedure.

If paid full-time management exists, the foundation executive board should limit itself to its strategic tasks (grant-making guidelines, fundamental decisions), and to monitoring tasks (supervising the management) and leave the operational tasks to the management.

When the separation between strategic and operational management in a foundation occurs at the boundary between volunteers and paid workers, conflicts can frequently be observed between the two that are typical for the nonprofit area and have been described as "functional dilettantism."<sup>37</sup> This involves failures to control and monitor that can arise from the ambivalence between the specialized knowledge and purpose-driven rationality of the paid employees, and the value orientation and group stabilization functions of the volunteer workers. The consequences can be disruptions in communication, increasing information gaps, distrust, power struggles, and thus the destabilization of the organization.

Frequently, an operational influence on all levels occurs in foundations in their most important area of activity – grant-making activities. However, it does not make sense, and is also hardly possible in larger foundations, for each application to be decided upon by the volunteers. It is an expression of weak foundational practice if the responsibilities or interfaces are not maintained, and if the appropriate basic decisions are not carried out, and in this way the offices responsible for operations cannot be effective and supported by the will and trust of their executive board members. For instance, if there is a lack of leadership in the volunteer bodies and important strategic decisions remain unresolved, for instance due to differing points of view, this can lead to a marked downward spiral in the power of the organization. The management must make decisions in the operational business that will be criticized by one or the other group and will always weaken management's position.

The decision-making process on grants, projects, and use of funds should therefore be clearly delineated and assigned. For instance, a pre-selection and resolution can be carried out by the management on the basis of clear requirements from the executive board or board of trustees. However, this method makes management into a sort of gatekeeper with a strong influence on the specific implementation of a grant-making policy. On the one hand, it would

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<sup>37</sup> Seibel, W., 1994. *Funktionaler Dilettantismus*. 2<sup>nd</sup> edition.

be inefficient and not goal-oriented to degrade the volunteers into members of an “endorsement committee,” what is called “completed staff work.” On the other hand, the danger exists that volunteer bodies work too operationally and that strategic considerations get short shrift (also due to time shortages).

#### 4 Individual board members

Good foundation governance also imposes requirements on the individual members of the foundation bodies. For instance, it should go without saying that they invest the necessary time and care in their volunteer foundation work. The members of the operating bodies should in principle be independent from the advisory and monitoring bodies. Personal identity between members of bodies in the grant-making foundation and recipients of grants should also be avoided. This does occur repeatedly, in order to include the specialist knowledge of the supported entity, for instance, and is also permitted by law. However, practice has repeatedly shown that it is rather a detriment to the discussion and decisions when, for instance, the head of a scientific institution has a seat on a decision-making body of a scientific foundation from which it receives considerable benefits.

In any case, good foundation governance means that members of foundation bodies and foundation employees do not allow themselves to be guided by selfish interests. It is not surprising that avoiding conflicts of interest is one of the main topics in the previously mentioned “Principles of Good Foundational Practice” from the Federal Association of German Foundations, since as grant-making organizations making autonomous decisions, foundations are particularly susceptible to this. These Principles state that the grounds for a conflict of interest in an individual case should be disclosed without being requested and affected persons should remove themselves from involvement in the decision-making process when it can provide them or a close associate with a direct advantage or disadvantage. Personal or familial relationships with those seeking grants and with service companies should also be communicated openly. Affected persons should renounce benefits in cash or equivalent that are provided to them by an interested party. This also applies when the relationship between benefit and consideration is not direct or can only be expected in the future. What is not expressly mentioned is a circumstance frequently occurs, where paid employees of grant-making foundations receive gifts or honors such as prizes, medals, honorary doctorates, or honorary professorships from institutions that received grant funds.

In order for the foundation to be effective, achieving good membership on the foundation bodies is indispensable. This is not always so very easy, considering their voluntary nature. The risk of conflicts of interest is thus quite large, because some motivation must exist. This motivation can also be financial benefits. Financial compensation for the amount of work performed ranges in practice from reimbursement of expenses, expense allowances, or attendance fees, up to lump-sum or performance-related honoraria. Remuneration can endanger the credibility of an organization that is not oriented to maximizing profits and subvert the independence of the body. Therefore, in addition to the appropriateness of the remuneration on a case-by-case basis, emphasis should be placed on finding other ways to make the volunteer office attractive. In any case, the general level of remuneration should be established in advance. Criteria for election and appointment, as well as requirements imposed on the incumbents and the overall composition of the body should also be laid down in advance.

## 5 Strategic decisions

The driving force of a foundation is its endowment. In the first place, its ability to yield a return must be preserved and expanded over the long term; communications and fundraising activities can be useful for this purpose. It is always important to keep in mind the tension between acting entrepreneurially and fulfilling charitable duties. Logical decision-making structures, a defined investment policy and strategy, and appropriate liquidity planning and financial budgeting are useful. Foundations in particular should reflect on whether it would also be sensible to consider other criteria besides financial ones. For instance, it could make sense for environmental foundations to invest in companies that meet special environmental standards. Religious and social foundations should not profit from companies that allow child labor. In this respect, a look at types of investments that meet ethical/ecological standards can be helpful.

## 6 Grant-making

Finally, a remark on the process of grant-making. Here, it is important that grant-seekers are not seen by the foundation's self-concept as supplicants, but rather as indispensable partners in the realization of the foundation's purposes. The granting of funds should be designed to be transparent and logical in order to preclude criticism and envy. It makes sense to develop the award procedure from the strategic decisions, and to largely formalize and standardize it. The grant conditions should be published. This makes the work easier for the applicants and the foundation. The comparability of individual projects is simplified and provides a basis for future evaluation. Serious inquiries should be answered in a timely manner, providing information on deadlines and the progress of application processing.

## 7 Communication

A keystone and significant basis for good foundation governance is the foundation's strategic communication. It derives the goals, content, and addressees that are important for it, as well as the instruments necessary to achieve it, from the purpose and identity of the foundation. It enables the foundation to clearly position itself and its issue, and to deal efficiently with the increasing need of the various stakeholders for information. Many foundations have not yet recognized the value of strategic communications and exercise the greatest of restraint, particularly to the outside. Increasingly, however, the motto is: "Do good and talk about it!"

## **IV Summary and conclusions**

In Germany there are hardly any cases of abuse with a foundational aspect in the focus of the media these days. Certainly, this does not mean that there are no such cases. Either they are not noticed, they are not serious enough, or they are prevented or regulated by their own self-concept or within the context of government monitoring.

If serious cases of negative foundation work were to become known and discussed publicly, this could reverse the direction of the reform efforts, which are currently oriented more towards deregulation and de-bureaucratization.

The development and implementation of "Principles of Good Foundational Practice" in the foundation associations and the foundations, and the continuation of the legal policy debate about the core of the foundational idea and trends leading to its instrumentalization can prevent possible misdevelopments.