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KNS BLOG

POSSIBLE ELEMENTS OF GOOD FOUNDATION GOVERNANCE

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Foundation governance is understood to represent all principles which refer to the management and monitoring of a foundation and its participants. Its purpose is to create an organisational structure which ensures the realisation of the foundation's purpose taking into consideration interests of the founder and the beneficiaries which are worthy of protection. Under Liechtenstein foundation law, there are different tools of internal and external foundation governance, and some of them will be presented briefly in what follows below. The concrete implementation of foundation governance and any tax consequences resulting therefrom need to be investigated on a case-by-case basis.

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POSSIBLE ELEMENTS OF GOOD FOUNDATION GOVERNANCE

Definition

In line with the term "corporate governance", foundation governance is understood to mean all principles and rules which refer to the management and monitoring of a foundation, including the position of the various participants in the foundation (e.g. founder, beneficiaries, etc.).

Under Liechtenstein foundation law, the basis for the implementation of clear governance rules has been created. In addition, other laws such as the Trustee Act (TrHG), the Due Diligence Act (SPG) and the related Ordinance (SPV) provide that the governing bodies of foundations have certain obligations designed to put in place protection against misconduct by the foundation council or other governing bodies, to create a fair balance between management and monitoring, and **to ensure the realisation of the founder's wishes** and foundation governance in the wider sense.

Purpose

The purpose of foundation governance is the creation of a **fair system of checks and balances**, i.e. of adequate rules regarding the **organisation and management of a foundation**, which are designed to protect the foundation and its participants in particular, but not exclusively, against misconduct by the foundation council (including other governing bodies). Governance rules may also include **guidance** to the foundation management on their tasks and the expectations placed by the founder on them.

Significance

Foundation governance enables founders, upon a foundation's creation or at a later point in time, to define an organisational structure to be followed by the foundation's governing bodies with the aim to implement the realisation of the foundation's purpose laid down by the founder in the declaration of establishment in the long term, thus making sure that the foundation **does not** slowly **become estranged from the founder's original wishes** during the term of the foundation. Practice has shown on more than one occasion that over time and especially in cases in which the founder is deceased and the beneficiaries have conflicting interests, it is very helpful that the founder has left at least rudimentary guidance. Otherwise, a great amount of time must be spent on determining the historical wishes of the founder, and there is a risk that the beneficiaries doubt the so determined visions and wishes of the deceased founder, in particular if they do not match their own. Adequate governance rules are thus conducive to **monitoring and ensuring the realisation of the founder's wishes by the foundation management in the long term**.

Foundation governance also makes it possible to **do justice to the interests of the foundation beneficiaries in line with the foundation's purpose and legal restrictions**. The longer a foundation's term is, the more important this becomes. It is a fact that the living circumstances and both the economic and the political situation change constantly. It would be an illusion to assume that a founder can foresee these changes. Any such changes may include changes in society, the internationalisation/globalisation of his/her own family, the sale of a family business, the number of family members, harmony within the family, the personal maturity and the expertise of beneficiaries and many other things. These changes require legal flexibility and good communication with the foundation participants, especially with the beneficiaries. In this context, good foundation governance can be used as a tool to **minimise the risks associated with these changes**.

From a *de lege lata* point of view, foundations are characterised by the fact that, by contrast to other types of legal entities, **there is no corporative element** (e.g. shareholders' general meeting and other

membership rights as for corporations). A foundation, as a legally independent special-purpose fund, has no shareholders who, by virtue of their position as owners, may exercise control over the foundation. This results in an **aggravation of the conflict between principal and agent** and in an **increased exposure of the foundation to abuse**, even if the foundation is always subject to judicial supervision. On the one hand, the logical consequence is that the **monitoring mechanisms** implemented for foundations **should be stricter** than those implemented for corporations or partnerships. On the other hand, however, this should not result in the creation of a rigid and bureaucratic legal entity.

Tools

1. Mandatory tools by virtue of the law

Under Liechtenstein foundation law, **judicial supervision** represents a tool of (external) foundation governance which has been laid down to be applicable to any and all foundations entered in Liechtenstein in the commercial register or deposited therein. There is no exception and this is mandatory. Only common-benefit foundations are required to be subject to **supervision by the Foundation Supervisory Authority (STIFA)**. These two tools of foundation governance cannot be contractually set aside or restricted by the founder or by the other participants in the foundation, as a result of which there is a legally defined minimum standard of foundation governance in all cases.

1.1. Judicial supervision

Article 552 § 35 of the Liechtenstein Persons and Companies Act (PGR) provides that all foundation participants are permitted to **file an application to the court for measures in special non-contentious proceedings**. Inter alia, this includes the right to file an application to the Princely Court of Justice (*Fürstliches Landgericht*) for supervisory measures such as the removal of governing bodies of the foundation or the conduct of a special audit, the annulment of foundation council resolutions as well as the modification of the foundation's purpose or other contents of the foundation documents.

The right laid down in Article 552 § 35 PGR is irrespective of whether the foundation is subject to internal or external supervision or not, and it **cannot be contractually set aside or restricted** by the founder.

In urgent cases and on the basis of a communication from the Foundation Supervisory Authority or the Office of the Public Prosecutor, the **supervisory court** can exercise the powers mentioned above and issue the necessary orders **ex officio**. A case is deemed to be urgent in particular if there is a strong suspicion that a governing body of the foundation has committed a punishable act.

1.2. Supervision by the Foundation Supervisory Authority (STIFA)

Pursuant to Article 552 § 29 PGR, common-benefit foundations are subject to supervision by the Liechtenstein Foundation Supervisory Authority (STIFA) by operation of law. In addition, **independent auditors** must be appointed for each common-benefit foundation (Article 552 § 27 PGR).

STIFA will make sure ex officio that **the foundation assets are being appropriated and managed in line with their purpose**. To this end, the Foundation Supervisory Authority is entitled to demand **information** from the foundation and to **inspect** the books and documents of the foundation through the auditors or directly. In addition, STIFA can, as part of its supervisory activity, obtain information from other administrative authorities and the courts and **file an application** to the Princely Court of Justice as supervisory court **for the necessary judicial orders**.

2. Optional tools

The **private autonomy principle** which is also applicable under Liechtenstein civil law as well as the largely non-mandatory provisions of Liechtenstein foundation law provide that upon the creation of a foundation the Founder has broad discretion to shape the foundation governance.

In general, a distinction is made between **external and internal foundation governance**, it being understood that external governance comprises supervision of

the foundation by **state / external bodies**. Internal foundation governance, however, means supervision of the foundation by the **participants** themselves.

Liechtenstein foundation law combines elements of external and internal governance and, within the restrictions of the law, **makes it possible to shape** supervision rights or specific directions with regard to governing bodies and participants of the foundation **more individually**.[1]

2.1. Internal governance

For **deposited foundations**, special importance must be given to internal governance. Deposited foundations are foundations which need not be publicly registered in the commercial register. In general, however, with regard to **private-benefit foundations** too, it is of great importance to shape internal governance with care, given that private-benefit foundations are not necessarily subject to supervision by the Foundation Supervisory Authority (STIFA).[2]

Examples of individual options of internal foundation governance are indicated below:

2.1.1. Founder's rights of modification and revocation

Pursuant to Article 552 § 30 PGR, the Founder may reserve **the right to revoke and/or modify the declaration of establishment in the foundation deed**. These rights can be neither assigned nor bequeathed.

If the founder is a **legal entity**, no such rights may be reserved. For foundations set up under foreign laws, in particular, it is common practice to have a legal entity (e.g. a company with limited liability) act as a co-founder, with the aim to be able to exercise the founder's rights through it in the long run. Even though under Liechtenstein foundation law it is indeed possible that legal entities act as (co-)founders, it must be noted that the rights of revocation or modification are reserved to individuals as founders exclusively.

As a general rule, these rights have detrimental effects under tax law and result in tax transparency of the foundation, which means that the assets comprised in the foundation are deemed to be owned by the founder. However, some tax jurisdictions (Austria, for example) allow the founder to exercise rights of revocation or modification.

2.1.2. Rights of the beneficiaries to information and disclosure

Insofar as the foundation is not subject to external supervision by the Foundation Supervisory Authority pursuant to Article 552 § 29 PGR or by a controlling body as defined by Article 552 § 11 PGR, all foundation participants, in principle and **by operation of law**, have a **right to information and disclosure** to the extent that their rights are concerned. In addition to that, they have rights to file applications and the standing of a party in special non-contentious proceedings. The beneficiaries therefore exercise important monitoring functions within the framework of internal governance. In principle, **all beneficiaries** have these rights, irrespective of whether they are entitled beneficiaries as defined by Article 552 § 6 (1) PGR (beneficiaries with a current legal entitlement), prospective beneficiaries as defined by Article 552 § 6 (2) PGR (beneficiaries with a legal entitlement in the event of the occurrence of a condition or at a specified time), discretionary beneficiaries as defined by Article 552 § 7 PGR (beneficiaries without a legal entitlement) or ultimate beneficiaries as defined by Article 552 § 8 PGR (beneficiaries with a legal entitlement after liquidation of the foundation). Ultimate beneficiaries, however, have no rights to information and disclosure before the foundation has been dissolved (Article 552 § 9 (3) PGR).

The rights to information and disclosure comprise the right of the beneficiary concerned to **inspect** the foundation deed and the supplementary foundation deed as well as the regulations (if any), to **receive**

[1] *Nueber/Thun-Hohenstein*, Neues zum Informationsanspruch von Begünstigten einer liechtensteinischen Stiftung, PSR 2018, 20.

[2] *Nueber/Thun-Hohenstein*, Neues zum Informationsanspruch von Begünstigten einer liechtensteinischen Stiftung, PSR 2018, 20.

information, obtain reports and the accounts with the right to inspect the business records and the business papers, as well as the right to conduct examinations and/or investigations (personally or through a representative), insofar as the rights of the respective beneficiary are concerned. However, oral information obtained from the foundation council is also covered by the right to disclosure.[3] In the event that the rights of the beneficiary refer thereto, there is a right, with regard to any holding company held by the foundation, to inspect the business records of these undertakings as well.[4]

In principle, recent court decisions and legal writings have interpreted these monitoring rights broadly and in favour of beneficiaries.[5] Principally, there is no restriction in terms of time with regard to the right to information under the law, which is why the right to information also refers to time periods prior to the point in time when the beneficiary acquired the status of beneficiary.[6]

Finally, the consequence of this right of the beneficiaries to information is that the foundation council is under an obligation to inform the current beneficiaries (at least those whose names are known) of their status of beneficiary in a proactive manner so that they are indeed in a position to exercise their legal rights. Until the beneficiaries have obtained knowledge of their status of beneficiary, they are not able to exercise their monitoring functions and additional functions within the framework of foundation governance, which is of special importance if no other governing body (such as an advisory board of the foundation) has been entrusted with these functions. In our view, this right, which has been recognised by legal scholars, primarily relates to the current beneficiaries mentioned by name, whereas the members of a class of beneficiaries who have been defined only in abstract terms have no such right to be informed of their (possible) entitlement. In many cases, the founder quite deliberately lays down a broad class of possible foundation beneficiaries so that future developments and changes in the founder's family, for example, can be taken account of. In such a scenario, it would not be practicable and not necessarily conducive to foundation governance, if a great number of persons were to be informed of their possible status of beneficiary. Upon the appointment of a member of the class of beneficiaries as beneficiary and usually upon such member receiving an allocation at the same time, the beneficiary concerned is generally informed of his/her beneficial interests, and as a result the foundation council fulfils its obligation to provide information on the beneficiary status. In cases of this kind, we recommend that the foundation be placed under supervision (see item 2.2.1 below) or that a controlling body be set up (see item 2.1.3 below) to secure the abstract class of beneficiaries.

2.1.3. Auxiliary bodies

Under Liechtenstein foundation law, it is possible to set up different auxiliary bodies which can perform different tasks from time to time. While the controlling body as defined by Article 552 § 11 PGR primarily performs monitoring tasks, other foundation bodies can be entrusted, pursuant to Article 552 § 28 PGR, with more or less extensive tasks of participation in the management of the foundation.

Controlling body

Concurrently with the declaration of establishment, a controlling body may be set up for the foundation in accordance with Article 552 § 11 PGR. If the founder has established such a body, the beneficiaries may only demand disclosure of information concerning the purpose and organisation of the foundation, and concerning their own rights vis-a-vis the foundation, and may verify the accuracy of this information by inspecting the foundation deeds and the regulations.

[3] *Gasser*, Liechtensteinisches Stiftungsrecht, Praxiskommentar[2] 182 marginal note 17 and 185 marginal note 20.
[4] *Gasser*, Liechtensteinisches Stiftungsrecht, Praxiskommentar[2] 184 marginal note 19.
[5] *Gasser*, Liechtensteinisches Stiftungsrecht, Praxiskommentar[2] 183 marginal note 17a, 185 marginal note 19 and 186 marginal note 21.
[6] see FL OGH 5.9.2015, 05 HG.2014.236 PSR 2016/10 = LES 2015, 2010.

The **extensive rights of the beneficiaries to information and disclosure** as mentioned above **are thus not applicable** if the founder has set up a controlling body for the foundation.

Pursuant to Article 552 § 11 (4) PGR, the controlling body is under an obligation to audit once a year whether the **foundation assets have been managed and appropriated in line with their purposes**. It must submit a **report** on the outcome of this audit to the foundation council. If there is no reason for objection, it shall be sufficient to provide **confirmation** that the foundation assets have been managed and appropriated in accordance with the purpose of the foundation and in conformity with the provisions of the law and the foundation documents. If, in the performance of its duties, the controlling body ascertains circumstances which jeopardise the existence of the foundation, it must **report this fact** to the beneficiaries (insofar as they are known to it), and to the court.

Setting up a controlling body pursuant to Article 552 § 11 PGR makes special sense if there are **legitimate reasons for restricting the beneficiaries' rights to information**. For example, the provision of information to a beneficiary can be made contingent upon his/her personal maturity, and certain information can be refused to him/her, if the founder or the foundation council takes the view that knowledge of such information by the beneficiary concerned might have detrimental or undesired effects on his future path in life.

Setting up a controlling body thus makes it possible **to restrict the beneficiaries' monitoring function** provided for under non-mandatory law, thus doing justice to legitimate confidentiality needs of the founder with regard to the foundation assets and the foundation management, while ensuring adequate foundation governance at the same time. The law provides for three possible independent controlling bodies:

1) The **founder**,
2) The **auditors**,
3) One or more **individual(s)** mentioned by the founder by name with specialist knowledge in the fields of law and business.

Other foundation bodies

Setting up a controlling body pursuant to Article 552 § 11 PGR must be distinguished from **setting up so-called "other foundation bodies"** pursuant to Article 552 § 28 PGR which leaves the beneficiaries' rights to information and disclosure unaffected.

A **foundation advisory board**, in particular, can be set up as another foundation body. The founder himself/herself or one or more member(s) of his/her family can be member(s) of the foundation advisory board. The appointment of a **protector** who/which can be an individual or a legal entity (a company with limited liability or an establishment, for example) is functionally the same as a foundation advisory board. The **tasks of the foundation advisory board** vary in practice, so that, apart from the function as a mere **monitoring body**, the foundation advisory board can also be granted more or less extensive **rights of participation in the foundation management**, including rights to give consent, to be heard, to cast a veto or to make proposals, for example. In order to be able to exercise its rights effectively, the foundation advisory board also needs to be granted **rights to receive information and disclosure** of information from the foundation council and other foundation participants, which rights are necessary for the foundation advisory board to perform its tasks. In practice, the presentation, by the foundation's auditors, of the audit report is of main importance. Quite often, the foundation advisory board is also endowed with the **right to appoint and remove** the members of the other foundation bodies, i.e. the foundation council and/or the auditors. Finally, the participation of the foundation advisory board may be indicated for **factual decisions** with importance to the foundation management, for example in connection with the modification of the foundation documents, distributions to the beneficiaries or the restructuration or termination of the foundation.

Under foundation law, it is also possible to appoint a so-called **collator**. A collator has the **right to appoint single beneficiaries** from among the class of beneficiaries defined by the founder in the foundation documents. Another common occurrence in practice is

that a legal entity is appointed as the collator the shares of which are held by the founder and/or the members of his/her family. The shares in this special-purpose vehicle and thus the right to appoint beneficiaries can be bequeathed or otherwise transferred.

2.1.4. Internal regulations

For the further specification of the foundation deed or the supplementary foundation deed, the founder, the foundation council or another governing body of the foundation may issue **internal directives in the form of regulations** if the right to do so has been reserved in the foundation deed (Article 552 § 18 PGR).

Any such regulations contain **implementing provisions regarding the primary foundation documents**, i.e. the foundation deed and the supplementary foundation deed from which they are derived. In the event of a conflict between a provision contained in the regulations and the provisions contained in the primary foundation documents, only the latter must be applied.

Regulations can be used in particular for the specification of powers, duties and competences of the **foundation's governing bodies** as well as for the determination of the internal procedures and the decision-making processes (e.g. as rules of procedure of the foundation council or as foundation advisory board regulations). Regulations may also contain **provisions on the fees granted to governing bodies of the foundation** and their entitlement to the reimbursement of expenses (fees regulations). Often regulations lay down specific provisions which are binding upon the foundation's governing bodies with regard to the **management and investment of the foundation assets** (asset management regulations). Finally, distribution regulations can be issued for the **specification of the distribution policy** and for **making distributions to foundation beneficiaries**. As regards discretionary foundations in particular, this creates a high degree of transparency for the beneficiaries with regard to the discretionary powers vested in the foundation council.

The **power to issue regulations** must be laid down in the foundation deed and can be granted to the founder or a governing body of the foundation. As early as upon the creation of the foundation in particular, the founder can issue one or more regulations or reserve this right to be exercised at a later point in time.

2.2. External governance

External governance as part of foundation governance means monitoring elements which are exercised by **independent third parties** rather than by foundation participants. The use of tools of external foundation governance is in principle associated with a restriction of internal monitoring rights, mainly those of the foundation beneficiaries.

The following examples of external foundation governance are set out below:

2.2.1. Voluntary supervision by the Foundation Supervisory Authority (STIFA)

Private-benefit foundations are not subject to external supervision by the Liechtenstein Foundation Supervisory Authority (STIFA). However, by including a provision to this effect in the foundation deed, private-benefit foundations can be placed under the supervision of STIFA voluntarily.

STIFA then makes sure ex officio that the **foundation assets are being managed and appropriated in line with their purposes**. In this process, **independent auditors** must be appointed for the foundation. The consequence of this kind of supervision is that the monitoring rights to which the beneficiaries are entitled pursuant to Article 552 § 9 PGR are suspended (Article 552 § 12 PGR).

2.2.2. Appointment of auditors

While the appointment of auditors is mandatory for common-benefit foundations pursuant to Article 552 § 27 (1) PGR, it is within the discretion of the founder of a private-benefit foundation to decide as to whether or not **auditors for the audit of the annual accounts** must be appointed for the foundation. In

addition, pursuant to Article 552 § 11 (2) (1) PGR, the founder may appoint **auditors as a controlling body**, as a result of which the rights of the beneficiaries to information and disclosure are restricted accordingly.

Article 552 § 27 (4) PGR provides that the auditors, as a governing body of the foundation, are under an obligation to audit once a year whether the **foundation assets are being managed and appropriated in accordance with their purposes**. They must submit a **report** on the outcome of this audit to the foundation council and, where applicable, to STIFA (if the foundation is under its supervision). If there is no reason for objection, it shall be sufficient to provide **confirmation** that the foundation assets have been managed and appropriated in accordance with the purpose of the foundation and in compliance with the provisions of the law and the foundation documents. If, while performing their duties, the auditors ascertain facts which jeopardize the existence of the foundation, they shall also report on this. If the foundation is subject to supervision by STIFA, the latter may demand from the auditors disclosure of all facts of which they have become aware during the course of the audit.

Limits of foundation governance

The manner in which foundation governance is shaped is firstly limited by the **mandatory provisions of Liechtenstein civil law** and by **foundation law** in particular. For example, the power to manage the foundation's business and to represent the foundation in its relations with third parties is reserved to the foundation council exclusively as a mandatory governing body of the foundation. It is thus impermissible that an auxiliary body such as the foundation advisory board actually act as the foundation council.

However, not only do the mandatory provisions of foundation law have to be complied with, but **in general it is not recommended to make full use of the extensive possible influence and rights of modification** which the liberal Liechtenstein foundation law grants to the founder. The ultimate question to be asked will always be what **the founder wishes** and what he/she does not wish. Generally, there is a fundamental interest on the part of the founder to exercise comprehensive control of the foundation assets and the foundation management even after the foundation's creation. This **departure from the principle of separation and solidification**, enshrined in foundation law, may, however, lead to detrimental side effects with regard to the **ownership** of the foundation assets **for tax purposes**, **asset protection** and the **minimisation of compulsory portion rights**, thus undermining essential objectives pursued by the founder to shape the foundation. For example, there is a risk that the founder's creditors - in particular if he/she is exposed to personal liability as an entrepreneur - seize a potential right of the founder to modification or revocation, thus gaining access to the assets comprised in the foundation. The reservation of a right of revocation is thus in **conflict with the intended asset protection function of the foundation**. Furthermore, if the founder has extensive powers to exert influence on, and to have access to, the foundation assets, this results in the fact that **no real financial sacrifice** has been made by the founder and that the transfer of assets will not trigger **any deadlines after the expiration of which the foundation assets are safe from being used for an augmentation of the compulsory portion**. Endowing assets to a foundation which is controlled extensively may thus lead to an undesired claim for augmentation of the compulsory portion by the founder's family members entitled to a compulsory portion, even if many years have passed between the transfer of assets and the founder's death.

During the foundation's creation, the founder will ultimately have to ask himself/herself about the **tax consequences** of the foundation's creation. Liechtenstein foundation law, which is extremely liberal by international standards, and the manner in which foundation governance may be shaped thereunder must be seen against the background of the restrictions applicable under the respective (foreign) tax law. In this context, the key question is as to whether the foreign tax jurisdiction regards the Liechtenstein **foundation** concerned **as a separate entity subject to taxation** (and thus as intransparent for tax purposes) and deems that the foundation assets and the income therefrom are owned by it, or as to whether the

founder himself/herself or one or more foundation beneficiary (beneficiaries) are regarded as the owners, for tax purposes, of the foundation assets and the income therefrom. In the latter case, the foundation is deemed to be **transparent for tax purposes**. The tax qualification is largely dependent upon the manner in which the foundation governance is shaped, and upon the rights reserved to the founder, his/her family or other participants. For example, the appointment of the founder as a member of the foundation council results in the fact that the foundation can no longer be qualified as intransparent under Austrian tax law, whereas such an appointment is accepted in Germany. On the other hand, the reservation of a right of modification or revocation in the foundation documents has no tax consequences under Austrian law, whereas both in Germany and in Switzerland any such foundation becomes transparent for tax purposes. Finally, special care must be taken when rights to remove the members of the foundation's governing bodies are granted, in particular if they can be removed without important reason.

Therefore, the **tax qualification of the foundation** in the jurisdictions concerned must always be **investigated on a case-by-case basis** so that undesired detrimental tax consequences can be avoided.

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