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THE LEGAL FRAMEWORK FOR RESTRICTED GIFTS:

THE CY PRES DOCTRINE

AND CORPORATE CHARITIES

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INTRODUCTION

While charity founders are free to choose the charity's organizational form, a separate question is the legal effect of this choice. Among the most important potential differences between charitable trusts and nonprofit charitable corporations are fiduciary standards and consequences for breach, levels of decisional autonomy for the governing board, and supervisory regimes. In these three important areas, however, trust and corporate law have been conforming, with the general result that corporate standards of care are being applied to fiduciaries, whether trustees or directors; trust doctrine is applying to changes in restrictions on gifts; and regulators have the same enforcement powers regardless of organizational form. This paper examines the second of these areas: the charitable trust law that applies to the creation and modification of restrictions on the use of charitable assets, and the consequences of extending that law to nonprofit corporate charities.

I. POTENTIALLY COMPETING POLICIES: HONORING DONOR RESTRICTIONS AND SOUND CHARITY GOVERNANCE

Although many gifts to charity carry no restrictions, charitable trusts and gifts to corporate charities might be restricted by the donor in a variety of ways: Terms might address specific purposes, longevity, geographic reach, manner of investment, and even rights of enforcement. In general, the law honors donors' restrictions on charitable gifts, often into perpetuity, in order to encourage charitable giving. In deciding between devoting their property to charitable use and keeping it in the family, donors take into account the likelihood that their donated property will remain governed by their wishes. Implicitly the state has determined that net social welfare increases by permitting the dead hand of the testator to dictate the enjoyment of donated wealth forever.[1]

Of course, restrictions can lose their relevance or even become impossible to perform. Accordingly, the power to create charitable trusts is protected by an equitable saving device, the judicial cy pres power, to deal with unanticipated circumstances. In applying the cy pres doctrine, courts traditionally seek to modify the trust to reflect what the donor would have wanted had the unanticipated circumstance been known at the time of the gift. As discussed

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[1] Some donors affirmatively disapprove of perpetuities. Most notably, see Julius Rosenwald, *Principles of Public Giving*, ATLANTIC MONTHLY, May 1929, *reprinted in* AMERICA'S VOLUNTARY SPIRIT 119 (Brian O'Connell ed., 1983); *see also* Julius Rosenwald, *The Trend Away from Perpetuities*, ATLANTIC MONTHLY, Dec. 1930, at 749. But even mandating a finite life can be hard to do. For an unusual case of thwarting donor intent in this reverse situation, see Brown v. Ryan, 788 N.E.2d 1183 (Ill. App. 2003). The three trustees of the $11-million Meyer Family Foundation won a declaratory judgment that the instrument permitted them to terminate the foundation at the end of its 50-year mandated life by distributing the corpus to a new, corporate foundation whose board they dominate. The appellate panel split two to one in rejecting the attorney general's argument that the result will "improperly allow the Trustees to evade the limitation placed on the duration of the Trust and to entrench themselves as trustees of the Meyer Trust assets for an indefinite period of time, perhaps in perpetuity."

below, similar principles apply to restricted gifts made to corporate charities.

Negotiating with a major donor over restrictions can be delicate and troubling for charity management, but until recently these restrictions have seldom presented legal issues. Most commonly, donors (or, frequently, their heirs) have been frustrated by the near-universal legal rule that private parties generally have no standing to enforce restrictions. Even though donor-imposed restrictions on charitable contributions are legally binding, traditionally only the state attorney general has standing to complain in court about a charity's governance, including its use of a restricted gift. Such a structure puts pressure on "the inclination and budget of a public official to vindicate [the beneficiaries'] rights."[2] In recent years, however, donors are increasingly attempting to influence charities' use of their gifts, sometimes employing novel giving vehicles and legal arguments to do so. These untested contracts expose the relatively primitive structure of current charity law. Applying standard property-law and contract-law concepts to public-benefit activities raises difficult issues of legal design, compliance, and enforcement.

After all, although a restricted gift constitutes an agreement between the donor and the charity, it is not merely a contract in the private law sense. An unidentifiable group of intended beneficiaries are the true beneficiaries. In sum, a gift once made is no longer the donor's property, and the fiduciaries of a charity must, within the bounds of their duties, be trusted to exercise their wisdom and discretion in the public interest. Most important, society depends on the fiduciaries, supported by the state, to recognize that "the" charitable interest changes over time and with changes in circumstances, and, when appropriate, to take action to seek modification of a restriction.

To complicate the issue, "donor intent" is enshrined in the law as the lodestar, but the term is shorthand for a web of actors and actions. A gift can be legally restricted because of conditions initiated and drafted by the donors' attorneys, or by actions taken by the charity itself in soliciting the gift.[3] Thus, it cannot always be said with confidence what the donor intended. While determining intent is a general problem in contract law, the longevity of the restriction in the charity context argues for increased scrutiny – and even skepticism – of claims about what the donor "would have" intended. A dispute over a restricted gift might arise many years later, perhaps after the donor's death. Moreover, arguments later made by the donor or by the donors'

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[2] Oberly v. Kirby, 592 A.2d 445, 468 (Del. 1991).

[3] In appropriate cases, even gifts solicited for a specified purpose will not be viewed as restricted. The Fourth Circuit, construing North Carolina law, refused to limit the use of donated funds to the specific solicited purpose: "Campaign publicity [for the annual March of Dimes campaign] . . . furnishes no basis for an inference that the donors, by their response, manifested an intention to so restrict their gifts that plans of operation and administrative practices might not be altered to increase the effectiveness of The National Foundation's service or its objectives . . . [, at] least so long as victims of poliomyelitis in Catawba County received adequate and proper care and assistance, as they did . . . . " National Fdn. v. First National Bank of Catawba County, N.C., 288 F.2d 831, 836 (4th Cir. 1961).

successors in interest – or by charity regulators – might proceed from motivations other than to further the donor's original charitable desires.

For example, consider geographic requirements. Donors often think locally, by donating to causes that benefit the community they know and by making donations whose value will be appreciated by the community that knows them. However, it is not always clear – particularly with the passage of time – whether the fact that the donor made a gift to a particular community is intended by the donor to impose a geographic restriction. As described below, an additional concern is parochialism in enforcement, by both attorneys general and courts, despite the absence of a geographic restriction in a gift.

Charities themselves are to some extent responsible for the existence of restrictions that turn out to be undesirable. Pressures to obtain funds and to be responsive to constituents lead charities to agree to restrictions, but charities have the obligation to accept restrictions carefully.[4] It might be prudent for a charity to adopt a "gift acceptance policy" calling for board approval before a restricted gift is accepted.[5] A charity should refuse to accept any gift carrying a restriction that cannot be released or modified if, in the determination of the charity, the restriction would conflict with its charitable mission or operations.[6] Of course, surprises can

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[4] See, for example, the Association of Fundraising Professional's essay on the emerging issue of "How Much Donor Involvement Is Too Much?", at <www.nsfre.org/ethics>, describing how restrictions might violate a nonprofit's mission statement or conflicts-of-interest policy, as well as public-benefit legal requirements. Several professional associations have promulgated codes of ethics or standards of practice that deal with restricted gifts. See, for example, American Association of Museums, "Guidelines for Museums on Developing and Managing Individual Donor Support" (Nov. 21, 2002), *available at* <www.aam-us.org/resources/ethics_guidelines/indivsupport.cfm>.

[5] Sample gift acceptance policies can be found on the Internet. See, for example, The University of Vermont, "Gift Acceptance Policy" (Aug. 1, 2001), *available at* <www.uvm.edu/~uvmppg/advance/list.html>. For a checklist of questions from a legal practitioner's perspective, see Simpson Thacher & Bartlett's "Decision Points for Drafting a Grant Agreement Between a Donor and a Charitable Gift Recipient" (July 2, 2002). For additional recommendations, see Eugene R. Tempel, *Donor Intent: Principles of Documenting a Gift*, NONPROFIT TIMES, Feb. 1, 2003, at 30.

[6] See Lacy Memorial Fund v. Norwest Bank Iowa, 641 N.W.2d 771 (Iowa 2002). Lacy bequeathed funds to Mid-State Scouting Council, a statewide organization that governs local scouting groups, for the benefit of troops in Lacy's hometown, Oskaloosa, Iowa. The will expressed the donor's intent that "the additional assistance which this fund will bring to the efforts of the residents of Oskaloosa may serve to make the effectiveness of these Oskaloosa organizations outstanding when compared with like services provided by cities of the same size." The Council, however, prepared the budget for the Oskaloosa troops without adjustment for distributions from the Lacy Trust, invoking its policy of centrally determining the relative needs of the troops. Moreover, the Council maintained that it has complied with the restriction because Oskaloosa's budget exceeds the funds the Council received from the Lacy Trust. The supreme court rejected these arguments, concluding: "If, as Mid-Iowa Council urges, it is contrary to basic principles of scouting to expend these funds for the exclusive use of scouting programs in Oskaloosa, then it should have, at the inception of the gifts, declined to accept them. We choose to give it that opportunity now." If the Council refuses to use "the trust distributions . . . in their entirety for the discrete and direct benefit of the boy scout programs in Oskaloosa", "the trustee is directed to make no further distributions to the Mid-Iowa Council and shall apply to the district court for directions for invoking the doctrine of cy-pres and

always occur, and a charity might receive a restricted bequest or devise without advance knowledge.

Still, despite their best intentions, many charities suffer incentive and agency problems, including poor internal communication and frequent staff turnover. The wooing of a major donor is a long-term endeavor, but neither the current development officer nor the donor might be available when it is time to deal with imprecise or poorly-thought-through restrictions. By the time a question about compliance with the restriction arises, relations between the charity and the donor (or the donor's descendants) might have soured. Memories can fail, or become self-serving, about promises that were made. Accordingly, a charity that accepts restricted gifts (or that raises funds for specific, identified purposes) should take steps to ensure that its staff and advisors are aware of their obligations and adhere to specified requirements.[7]

When possible, a charity that accepts a restricted gift should work with the prospective donor to include terms in the gift instrument that set forth clearly the scope of a restriction and the donor's desires for altering the restriction to adapt to unanticipated circumstances and the passage of time. For restrictions that arise from the charity's solicitation, the solicitation material or memorandum of acceptance should contain similar provisions. If unanticipated circumstances prevent a charity from adhering to the restriction and the gift instrument is silent, the charity must seek release or modification of the restriction.

II. UNANTICIPATED OR CHANGING CIRCUMSTANCES

A. Modifying Restrictions on Gifts

1. The trust doctrines of cy pres and equitable deviation

When is relief from a restriction appropriate, and what relief is appropriate? Assume the legally clearest case: a charitable trust whose settlor makes no provision for unanticipated circumstances. If the restriction relates to the donor's charitable purpose, the courts apply the doctrine of cy pres: When the restriction becomes impossible, impracticable, or unlawful to carry out, the court – purporting to determine what the settlor would have wanted had he or she known of the unanticipated circumstance at the outset – traditionally chose a new purpose by departing as minimally as possible from the original charitable purpose (the law French term was "*cy pres comme possible*"). By contrast, when the restriction is merely administrative, the courts apply

substituting a different local charitable organization . . . ."

[7] New York's Not-for-Profit Corporation Law, section 513(b), provides, in relevant part: "The governing board shall cause accurate accounts to be kept of such assets separate and apart from the accounts of other assets of the corporation. Unless the terms of the particular gift instrument provide otherwise, the treasurer shall make an annual report to the members (if there be members) or to the governing board (if there be no members) concerning the assets held under this section and the use made of such assets and of the income thereof."

the more flexible trust doctrine of equitable deviation. Although the trend is not universal, recent years have brought a broadening of the circumstances under which these doctrines are applied and modification granted.

Of course, if the donor had so provided, a restriction may be modified pursuant to the process set forth in the gift instrument. Separately, a restriction may be released (in whole or part) in states that have adopted the Uniform Management of Institutional Funds Act, discussed below.

2. Distinguishing between administrative and purpose restrictions

Traditionally, while cy pres focuses on the "ends" (the charitable purpose or goal) and the doctrine of deviation (called approximation in some states) focuses on the "means" of achieving a particular charitable purpose, the line between administrative restrictions and purpose restrictions is not always clear.[8]

Restrictions relating to investment assets would appear always to be administrative unless the investment independently furthers a charitable purpose of the charity (other than for the production of funds). Accordingly, the more liberal standards of deviation should ordinarily be available in the investment context. Interpretative issues remain in two areas: investments that might be viewed as furthering a charitable purpose aside from the organization's need for funds, and original (or "inception") assets donated out of mixed private and public motives.[9]

3. Threshold failure of the designated restriction.

Traditionally, application of both the doctrine of deviation and cy pres is subject to a finding that the original restriction cannot be fulfilled. However, the threshold tests differ, even as liberalized by recent legal reform projects. Under the *Restatement (Third) of Trusts* (2003), modification of an administrative restriction requires only that circumstances not anticipated by the donor hinder the charitable purposes of the gift. Under both the *Restatement (Third) of Trusts* and the new Uniform Trust Code (2000),[10] cy pres is available to modify charitable purposes that

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[8] *See* Trustees of Dartmouth College v. City of Quincy, 258 N.E.2d 745, 753 (1970) ("It is not wholly clear in all instances whether a particular decision involves (a) only construction of a charitable trust or a reasonable deviation, in the public interest, from its subordinate provisions, or (b) a traditional cy pres application. . . ."); Daloia v. Franciscan Health System, 679 N.E.2d 1084 (Ohio 1997). Moreover, the *Restatement (Third) of Trusts* (2003) makes deviation available not only for administrative matters but also for distributive provisions.

[9] See discussion of the Hershey Trust's abandoned consideration of selling its controlling interest in Hershey Foods Corporation, below.

[10] 7C U.L.A. 61 (2000). According to the website of the National Conference of Commissioners on Uniform State Laws (www.nccusl.org), by year-end 2003, the Uniform Trust Code was enacted in Arizona, the District of Columbia, Kansas, Nebraska, New Mexico, Utah, and Wyoming, and is being introduced in 2004 in Colorado, Maine, Massachusetts, Missouri, New Hampshire, Oklahoma, Pennsylvania, Tennessee, Virginia, and

have become not only impossible, impracticable, or unlawful but also "wasteful."[11] (Compare an identical test in the proposed revision to UMIFA, mentioned below.)

To the extent wastefulness is a matter of surplus, one might view waste and narrowness of purpose as two sides of the same coin: The more constricted the charitable class, the more likely will the designated fund exceed the needs of that class, particularly (but not necessarily) over time. Even without applying the concept of waste in this context, some courts have construed "impracticability" liberally enough to reach the same end. In granting petitions to modify restrictions regarding the designated charitable class, courts have been most amenable to terminating racial restrictions; often, but not universally willing to relax gender and religious restrictions; and least receptive to relaxing geographic restrictions. It can be hard to generalize, though, as states vary in their willingness to apply cy pres.

The most notorious American cy pres case involved the Buck Trust. To simplify, in 1975 Beryl Buck bequeathed $10 million worth of oil company stock to a trust for the benefit of Marin County, one of the richest in the country. Ten years later, when the stock had ballooned in value to $400 million, the trustee possessing distribution powers sought court approval to spend some of the income to benefit the greater San Francisco Bay area. The attorney general opposed on the ground that the original restriction was not impossible to carry out. The court agreed, and denied cy pres relief; reasoning "that all of the Buck Trust income could be spent effectively and efficiently in Marin County" and "that the geographic restriction in the Buck Trust was 'unequivocal.'"[12] The distribution trustee resigned and was replaced. Professor John Simon would have applied cy pres in the Buck Trust case not merely on grounds of inefficiency, but on a theory of "posthumous surprise" – that had Beryl Buck known she was disposing of $400 million rather than $10 million, she would not have framed the restriction as she did.[13]

Compare a federal district court in Virginia that granted the cy pres petition of the Coast

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West Virginia.

[11] The *Third Restatement* explains in a parenthetical comment on the use of surplus funds: "(The term 'wasteful' is used here neither in the sense of common-law waste nor to suggest that a lesser standard of merely 'better use' will suffice.)" Section 67, Comment *c(1)*. The *Third Restatement*, Comment *c* to § 67, states: "if a testator devises property in trust to establish and maintain an institution of a particular type but a similar institution already exists and is sufficiently effective that the testator's plan would serve no useful purpose, the intended purpose will not be enforced." (Compare the discussion of waste under § 29 of the *Third Restatement*, and Reporter's Notes on Comment *m* reviewing cases that refused to uphold trust directions that amounted to waste.) Similarly, the Reporter for the Uniform Trust Code explains: "Cases of waste normally involve situations where the funds allocated to the particular charitable scheme far exceed what is needed." David M. English, *The Uniform Trust Code (2000): Significant Provisions and Policy Issues*, 67 MO. L. REV. 143, at n.164 (Spring 2002) (discussing Uniform Trust Code § 413(a)).

[12] In re Estate of Buck, No. 23259 (Cal. Super. Ct. 1986), *reprinted at* 21 U.S.F. L. REV. 691 (1987); *see also* Estate of Buck v. Marin Community Foundation, 35 Cal. Rptr. 2d 442, 443-44 (Cal. App. 1994).

[13] John G. Simon, *American Philanthropy and the Buck Trust*, 21 U.S.F. L. REV. 641, 663 (1987).

Guard Academy for a donated fund whose income was to be awarded each year to the graduating cadet with the highest grade in physics and chemistry. The income was so high that the Academy declared that it would refuse the gift unless the court permitted most of the income to be used for science fellowships and visitorships.[14]

In some cases, it can be hard to detect a principle for crafting the modification.[15] For example, the Supreme Judicial Court of Massachusetts approved applying cy pres to a dollar-limited scholarship program for male congregants of the settlor's very small church to attend Harvard as undergraduates. As modified, funds would be available, if necessary, in unlimited amounts and also for female students and non-coreligionists – but still only for attending Harvard (albeit as graduate students or undergraduates).[16] The court expressed the view that "no purpose, least of all the settlor's, is served by tying up funds intended for charitable use with the thin thread of a theoretically possible (but unlikely) change in circumstances." Apparently there was no challenge to the view of the testator's charitable purpose as being to benefit Harvard; the court did not address the possibility of instead allowing scholarships for all communicants of the testator's church regardless of the school attended.

Of course, not all cy pres cases are a matter of surplus. See, for example, the case of the Museum of the American Indian, most of whose artifact collection eventually moved from New York to Maryland and Washington, D.C., when the Smithsonian rescued the financially troubled charity.[17] A separate matter relating to the book collection is ongoing.[18]

4. Standard for modification

Once it is determined that deviation or cy pres is available, the next step is to determine the appropriate modification. Section 66 of the *Restatement (Third) of Trusts* allows deviation to "further the purposes of the trust." For cy pres, § 67 of the *Third Restatement* states that "the

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[14] United States v. Cerio, 831 F. Supp. 530 (E.D. Va. 1993).

[15] See, e.g., the convoluted proceedings in Lockwood v. Killian, 425 A.2d 909 (Conn. 1979).

[16] Wesley United Methodist Church v. Harvard College, 316 N.E.2d 620 (Mass. 1974); note that "defendant Harvard College did not file an answer, and the Attorney General waived his right to be heard." See also Howard Savings Institution v. Peep, 170 A.2d 39 (N.J. 1961) (applying cy pres to allow Amherst College to accept a bequest for scholarships for "deserving American born, Protestant, Gentile boys of good moral repute, not given to gambling, smoking, drinking or similar acts," without the religious restrictions that conflicted with its charter).

[17] Museum of the American Indian v. Huntington Free Library, 610 N.Y.S.2d 488 (1994), discussed in JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS 130-34 (2d ed. 2000).

[18] See In the Matter of Board of Trustees of the Huntington Free Library and Reading Room, 2002 N.Y. Misc. LEXIS 1474 (N.Y. Supreme Ct. 2002) (denying an order to approve the Stipulation of Settlement between the Library and the attorney general for the transfer of the book collection to the New York State Historical Association, located in Cooperstown). *See generally* Leslie Eaton, *A Bronx Library's Peculiar Catch-22; Prize Collection Becomes a Curse, and Perhaps a Death Knell*, N.Y. TIMES, Nov. 18, 2002, at B1.

court will direct application of the property or appropriate portion thereof to a charitable purpose that reasonably approximates the designated purpose." Comment *d* adds: "Increasingly . . . courts have recognized (as does this Section) that the substitute or supplementary purpose need not be the *nearest possible* but one reasonably similar or close to the settlor's designated purpose, of 'falling within the general charitable purpose' of the settlor."

5. Are restricted gifts to corporate charities trusts?

The treatment of gifts to corporate charities varies in theory among the states, but not in effect. Under any approach, the charity has a general duty to adhere to the restriction.[19] Some legislatures have declared that a charitable nonprofit corporation is deemed to be a trust and its board of directors to be trustees. In some other states it is the courts that treat the charitable class served by the corporate charity as the beneficiaries of a trust.[20]

The *Restatement (Third) of Trusts* applies only to those gifts made to corporate charities that carry restrictions, but not to gifts made for the general purposes of a corporate charity.[21] Some courts go further, however, and reject trust treatment even for a restricted gift made to a corporate charity. Notably, at a time when charitable trusts were illegal in New York, the state high court saved the charitable corporation by ruling: "The corporation uses the property, in accordance with the law of its creation, for its own purposes; and the dictation of the manner of its use, within the law by the donor, does not affect its ownership or make it a trustee. A person . . . cannot be a trustee for himself."[22] Nevertheless, the court held:

> No authority has been brought to our attention that a gift to a charitable corporation with the express direction that it be applied to a specific corporate purpose in a specific manner may be accepted by the corporation, and then used for a different corporate purpose in a different manner. No trust arises, it is true, in a technical sense, . . . for the trustee and beneficiary are one. . . . [The charitable corporation] may not, however,

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[19] See, e.g., Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 647 (1819) (philanthropy was founded on the hope that the funds would "flow forever in the channel which the givers have marked out for it"). Wrote Justice Marshall: "a great inducement to charitable gifts is the conviction felt by the donor that the disposition is immutable and that the corporation constitutes the security for such gifts." 17 U.S. at 647.

[20] *See generally Duties of Charitable Trust Trustees and Charitable Corporation Directors*, 2 REAL PROP. PROB. & TR. J. 545, 547 (1967).

[21] Section 28, General Comment *a*: "An outright devise[] or donation to a nonproprietary hospital or university or other charitable institution, expressly or impliedly to be used for its general charitable purposes, is charitable but does not create a trust as that term is used in this Restatement. A disposition to such an institution for a specific purpose, however, such as to support medical research, perhaps on a particular disease, or to establish a scholarship fund in a certain field of study, creates a charitable trust of which the institution is the trustee for purposes of the terminology and rules of this Restatement."

[22] St. Joseph's Hospital v. Bennett, 22 N.E.2d 305, 307 (N.Y. 1939).

receive a gift made for one purpose and use it for another, unless the court applying the cy pres doctrine so commands.[23]

Separate from the question of the corporate charity's obligation to honor a restriction is the potential liability of the corporation's directors. The Revised Model Nonprofit Corporation Act explicitly rejects the view that directors of corporate charities are trustees. Section 8.30(e) provides: "A director shall not be deemed to be a trustee with respect to the corporation or with respect to any property held or administered by the corporation, including without limit, property that may be subject to restrictions imposed by the donor or transferor of such property." Official Comment 1 explains that "the corporation, as distinguished from its director, may hold or be deemed to hold property in trust or subject to restrictions." Even in states that do not treat directors as trustees, a breach of a gift restriction can, depending on the circumstances, reflect wrongdoing by the charity or by its fiduciaries or both.[24]

6. Uniform Management of Institutional Funds Act

Traditionally, the law did not accommodate a donor who later regretted or was willing to alter gift restrictions. For the last thirty years, the Uniform Management of Institutional Funds Act, adopted (sometimes with variation) in 47 jurisdictions, has provided a mechanism for releasing donor restrictions on institutional funds.[25]

UMIFA Section 7(a) provides that, with the donor's written consent, the charity's "governing board may release, in whole or in part, a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund." If written consent cannot be obtained because of the donor's death, disability, unavailability, or impossibility of identification,

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[23] *Id.* at 308. New York has codified this result in Section 513 of the Not-for-Profit Corporation Law. See also Persan v. Life Concepts, Inc., 738 So.2d 1008, 1010 (Fla. App. 1999):

> Making a gift to a charity for a specific project or purpose does not create a charitable trust. For this court to suggest that it does would create havoc for charitable institutions. A charity has to be able to know when a donation is a gift and when it is merely an offer to fund a trust for which the charity is taking on fiduciary responsibilities. The creation of such a trust must be express.

[24] One recent commentary cautions fiduciaries: "Directors/Trustees of non-profit corporations should not underestimate the untoward consequences that may result from ignoring trust/gift restrictions. These risks can be both institutional (loss of control of the restricted funds; injunctive relief to restrict corporate actions; restitution to the restricted fund, etc.) and personal (surcharge and/or removal of directors or, in worst case scenarios, criminal prosecution). As such, it is crucial to take care in dealing with such funds." Michael Peregrine and James Schwartz, *A General Counsel's Guide to Accessing Restricted Gifts,* 29 EXEMPT ORGANIZATION TAX REVIEW 27, at ¶ 52 (July 2000).

[25] Uniform Management of Institutional Funds Act ("UMIFA") (1972). Generally, an "institution" is an organization formed and operated exclusively for educational, religious, charitable, or other eleemosynary purposes. The proposed revision to UMIFA, mentioned below, would extend UMIFA to trusts, whose prudent investing has already been covered by other legal reform projects.

then the governing board may apply to court for release of the restriction. The charity must notify the attorney general, who may intervene. The court may release any restriction, in whole or in part, that it finds to be "obsolete, inappropriate, or impracticable," a test that was intended to be more flexible than the then-understood cy pres standard.

Apparently, under UMIFA an approving court can only release the restriction in whole or in part, after which the charity is free to use the gift in any manner it desires.[26] The few cases implicating the relationship between release of a restriction under UMIFA and the cy pres doctrine did not declare one way or the other how the two provisions interact. Some cases did not reach the question.[27] In the other cases, the applied-for new use either satisfied the stricter cy pres requirement anyway[28] or failed both.[29] The National Conference of Commissioners on Uniform State Laws has opened a revision project on UMIFA.[30]

B. Change in Charitable Purpose and Use of Pre-Amendment Assets

Generally, the charity fiduciaries' twin duties of loyalty and care combine to require charity trustees and directors to keep the funds productive for the benefit of a charitable class. Facially, however, both the authority to change purposes and the standard of permitted new purpose differ under trust and corporate law.[31] In the case of a charitable trust, unless the trust

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[26] See Yale University v. Blumenthal, 621 A.2d 1304 (Conn. 1993), particularly the dissent at 1311: "[I]n the comments to the uniform act there is not even a suggestion that it was the intent of the drafters to require the application of cy pres, even if equity dictates, if the fund is designated an institutional fund. The institution may choose to invoke cy pres, but if it fails to do so, the court's discretion under CUMIFA is to release in whole or in part the restriction or to deny the application." However, in Ronald Chester's view, "if an institution . . . applies for a release of gift restrictions under UMIFA, the court has the option to release fully or partially, or to modify in accordance with *cy pres* (or by extension, administrative deviation) the gift at hand." Ronald Chester, *Grantor Standing to Enforce Charitable Transfers Under Section 405(c) of the Uniform Trust Code and Related Law: How Important Is It and How Extensive Should It Be?*, 37 REAL PROP., PROB. & TR. J. 611, 628 (2003).

[27] *See* Carl J. Herzog Foundation, Inc. v. University of Bridgeport, 699 A.2d 995 (Conn. 1997) (standing denied); In re Estate of Murdock, 884 P.2d 749 (Kan. 1994) ("the trustee presented no evidence on which the trial court could have granted it relief under any standard"); Yale University v. Blumenthal, 621 A.2d 1304 (1993) (determining whether Yale was an institution).

[28] *See* Hartford Hospital v. Blumenthal, 1996 Conn. Super. LEXIS 994 (1996); Smith Memorial Home v. Riddle, 1990 Conn. Super. LEXIS 1498 (1990).

[29] *See* In re Estate of Estes, 523 N.W.2d 863 (Mich. App. 1994).

[30] An August draft received its first reading at NCCUSL's annual meeting. NCCUSL requires a second reading of its uniform acts. A March 2004 circulation draft can be found on NCCUSL's website at <http://www.law.upenn.edu/bll/ulc/umoifa/Mar2004CircDraft.htm>.

[31] *See generally* Rep. of [A.B.A.] Comm. on Charitable Trusts, *Duties of Charitable Trust Trustees and Charitable Corporation Directors*, 2 REAL PROP., PROB. & TR. J. 545, 548-54 (1967), discussing, under the general heading "Duty to Comply with Donor's Directions" the following topics: (1) Amendment of Charter; (2) Merger or

instrument gives the trustees the authority to amend the charitable purpose, the fiduciaries must apply to the court for relief if the designated purpose can no longer be followed. In the case of a nonprofit corporation, is a more flexible standard appropriate and available?

Some commentators find a third duty of charity fiduciaries: the "duty of obedience" to the organization's original mission. Such a duty would have particular application to nonprofit corporations, because of the power typically enjoyed by the directors to amend the articles of incorporation, including the purposes clause.[32] A consequence of recognizing such a duty of obedience would be to impose on corporate boards the strictures of the cy pres doctrine. However, transporting the cy pres doctrine from its trust context – in which the trustee is typically more of an administrator – can unduly interfere with the governance function of the typical nonprofit corporation. The legal structure generally is not designed to induce board members to take risks in difficult situations.[33] Mandating the application of the cy pres doctrine to a re-evaluation of corporate mission could further the expectation that charity managers must honor the original purposes of the charity to the utmost extent: The fiduciaries might reasonably believe that it is legally safer to continue the course while the organization deteriorates.

Other commentators view the traditional duties of loyalty and care as subsuming a faithfulness to mission, but perhaps with some flexibility. Indeed, rather than conceptualizing a duty of obedience to a particular mission, it might make better policy to impose on the members of the governing board a duty to keep the purpose of the charity current and useful. After all, the degree of obedience is one of the choices the founders make in selecting the charity's organizational form, as trust or corporation.

1. Corporate board's authority to change purpose

The power to amend the charitable purpose of the corporation is vested by nonprofit corporation statutes in the board of directors. Nevertheless, drafters of the American Bar Association's Revised Model Nonprofit Corporation Act worried about whether a corporate charity (unlike a trust) can alter its purposes without applying to court for cy pres relief, quoting *Attorney General v. Hahnemann Hospital*: "Those who give to a home for abandoned animals do not anticipate a future board amending the charity's purpose to become research vivisectionists."[34] Some state statutes require the charity to notify the attorney general or to go to

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Consolidation; (3) Dissolution; (4) Restricted Purpose.

[32] The *Restatement (Third) of Trusts* is addressing similar issues in § 76 (Duty to Administer the Trust in Accordance with Its Terms). See Preliminary Draft No. 6 (May 23, 2003).

[33] Economist Henry Hansmann describes how regulatory structures – and the combination of history and culture that he calls "institutional inertia" – already lock assets into the nonprofit sector. HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 295-96 (1996).

[34] 494 N.E.2d 1011, 1021 n.18 (Mass. 1986).

court in cases of organic change, including change in charitable purpose, especially where restricted gifts are involved.[35] A nuanced approach would be to distinguish between shifting purposes within the same field or expanding the charitable class, on the one hand, and substantial changes of purpose (as in the anti-vivisectionist example), on the other hand. Changes of purpose in the latter category might better be made subject to greater public oversight or an elevated standard of review.[36] Thus, a college – whether financially healthy or struggling – could be permitted to close a department without resort to the attorney general and courts, but liquidation or merger could require notice and approval.[37]

While a change of activity within a given purpose is not a change in purpose, the line is not always clear. Moreover, some courts prohibit a charity from "abandoning" its purpose as expressed in its operations.[38]

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[35] As a practical matter, the charity might, prior to the cy pres filing, negotiate proposed changes with the attorney general's office, which has a similar interest in arriving at a useful restructuring in order to avoid multiple trips to court. However, an agreement between the charity and the attorney general might still have to be approved by the court.

[36] *See, e.g.*, Harvey J. Goldschmid, *The Fiduciary Problems of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631 (1998); James J. Fishman, *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-Profit Status*, 23 J. CORP. L. 701 (1998).

[37] Compare the Wilson College case, where the trial court prohibited the financially struggling school from closing. Zehner v. Alexander, Pa. Ct. Common Pleas, Orphan's Court Div. (1979), excerpted in JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS (2d ed. 2000). See criticism of this case in Harriet M. King, *The Voluntary Closing of a Private College: A Decision for the Board of Trustees?*, 32 S.C. L. REV. 547 (1981); Hazel G. Beh, *Downsizing Higher Education and Derailing Student Educational Objectives: When Should Student Claims for Program Closures Succeed*?, 33 GA. L. REV. 155 (1998).

[38] California courts prohibit a corporate charity from "abandoning" its purpose not only as declared in its articles of incorporation but also through its operations. *See* Queen of Angels Hospital v. Younger, 66 Cal. App. 3d 359 (1977) (applying strict cy pres, requiring sale proceeds to be used to carry out charity's original purpose: operation of a hospital). *Queen of Angels* cited to Holt v. College of Osteopathic Physicians and Surgeons, 394 P.2d 932 (Cal. 1964), which granted trial to hear allegations by three of the 26 directors that the decision by the other directors to amend the articles of incorporation constituted a breach of charitable trust. "Whether the teaching of allopathic medicine as threatened by defendant trustees will change the teaching emphasis at COPS contrary to the charitable purpose of conducting an osteopathic college presents a question of fact that cannot be decided on demurrer." *Id.* at 939. The court held that the minority directors had standing independent of that of the attorney general, who did not object to the amendment.

Contrast an Illinois case involving a nonprofit Methodist hospital corporation whose purpose was to operate "hospitals." The Illinois supreme court held that: "Abandonment of a *particular* hospital site is not in conflict with the conceptions of the incorporators." Holden Hospital Corp. v. Southern Illinois Hospital Corp., 174 N.E.2d 793, 797 (Ill. 1961) (emphasis added). As to the provision in the articles of incorporation stating "The location is in the city of Carbondale," the court concluded: "the charter . . . mentions Carbondale only to designate the location of the corporation's office." *Id.* The facts revealed a long history of operating a hospital in that city, and "that since its incorporation Holden has received strong financial support both from the Methodist Church and its affiliated organizations, and from individuals and secular organizations in Carbondale . . . made free of any restrictions or provisions for reverter." *Id.* at 795. The nonprofit buyer of the assets would continue to operate the hospital.

The argument for an explicit and distinct duty of obedience is made by former New York charity regulator Daniel Kurtz and others.[39] This duty was accepted by a New York trial court in *Matter of the Manhattan Eye, Ear & Throat Hospital v. Spitzer* ("MEETH"), which ruled that "the duty of obedience, perforce, must inform the question of whether a proposed transaction to sell all or substantially all of a charity's assets promotes the purposes of the charitable corporation . . . .[40] However, in an earlier case, the New York Court of Appeals applied a "quasi-cy pres" standard to distributions by liquidating corporate charities. The high court relied on the language of the not-for-profit corporation statute that provides for a more lenient standard, finding that "it is the board of directors which adopts the plan of distribution" and that the legislature "intended also that not-for-profit corporations have 'a strong board of directors'. . . ."[41] Thus, the court proceeding is to accord deference to the board's determination instead of permitting the judge to substitute his or her judgment.

To the same effect as a duty of obedience but addressing a different concern, claims are sometimes made that the value of a charity's assets "belongs" to the community that has provided it with tax subsidies. Health care "conversions" from nonprofit to for-profit status have brought increased activism on the part of attorneys general, who frequently enjoy new powers under recent targeted legislation. Spurred by a few early, poorly supervised conversions leading to the sale of nonprofit assets to hospital insiders at favorable prices, legislatures in 27 states have adopted "nonprofit hospital conversion statutes."[42] The conversion statutes typically require, among other things, public notice and the right of the attorney general to intervene in a proposed sale of assets by a nonprofit hospital corporation to a for-profit (but usually not nonprofit) buyer. Once the deal is allowed to proceed, the statutes continue the cy-pres constraint: The resulting funds must be used for "health care purposes" in the community that the hospital served. In the absence of such a statute, not all trustees have hewn to the original charity's path. One conversion foundation determined that federal and state programs adequately meet the needs of most uninsured patients, and so shifted its focus to education.

Accordingly, the court rejected the trial court's application of cy pres: "Cy pres is only of importance when there is a need to divert property from one purpose to another; here. . . it should be of little consequence to anyone that Holden's assets are administered in the future not by Holden but by some other corporation under similar restrictions." *Id.* at 798.

[39] See DANIEL L. KURTZ, BOARD LIABILITY: GUIDE FOR NONPROFIT DIRECTORS (1988).

[40] 715 N.Y.S.2d 575, 593 (1999). Upholding the attorney general's objection to the sale of assets by one nonprofit hospital to another, the court observed: "Embarkation upon a course of conduct which turns it away from the charity's central and well-understood mission should be a carefully chosen option of last resort. Otherwise, a Board facing difficult financial straits might find sale of its assets, and 'reprioritization' of its mission to be an attractive option, rather than taking all reasonable efforts to preserve the mission which has been the object of its stewardship." *Id.* at 595.

[41] In the Matter of Multiple Sclerosis Service Organization, 496 N.E.2d 861, 868 (N.Y. 1986).

[42] *See* Marion R. Fremont-Smith & Jonathan A. Lever, *State Regulation of Health Care Conversions and Conversion Foundations*, 9 B.N.A. HEALTH LAW REPORTER 714 (May 11, 2000).

2. Consequences of change in charitable purpose

As a threshold matter, in appropriate circumstances the charity board has an obligation to take action that could cause it to breach one or more restricted gifts.[43] If, though, the charity cannot use the restricted gift for its original purpose, then the charity must obtain approval to a modify (or release) the restriction.[44]

Other corporate assets fall into two general categories: unrestricted gifts and non-donated assets (i.e., earned income and investment income (other than on gifts)). An approach that allows non-donated assets to be directed by the board to any charitable purpose, including the new purpose, permits liberal corporate charity governance with respect to income earned by the sale of goods and services, as well as with respect to investment income on earnings and unrestricted gifts. This policy could be extended to all of the corporate charity's unrestricted gifts – that is, gifts made for general corporate purposes. In effect, for assets that were donated but not subject to explicit restriction, the donor might fairly be presumed to consent to a future amendment to purpose. After all, (1) donors who want to impose restrictions may do so; (2) donors who make general gifts should appreciate that charities must adapt to changing circumstances; and (3) unrestricted gifts can reasonably be viewed as expended first, and so used to satisfy any intended (but unexpressed) intention of the donors.

Such a liberal approach to the post-amendment use of pre-amended unrestricted assets is not uniformly followed. Notably, the Supreme Judicial Court of Massachusetts recognized the right of the board of a nonprofit corporate hospital to amend its articles of incorporation to allow it to sell its assets, rejecting the attorney general's argument that the board of a nonprofit

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[43] Thus, for example, in *In re Estate of Eugene du Pont*, Chancellor Allen explained: "The board of the Medical Center has a responsibility to try, in an informed and well motivated process, within the law, to provide high quality hospital and related health care services in a cost efficient manner. If it is more efficient for the Medical Center to provide rehabilitation services at Wilmington Hospital than at Pelleport, no obligation of the Medical Center arising from the acceptance by its predecessors of the Eugene du Pont gifts prevents it from doing so." 663 A.2d 470, 479 (Del. Ch. 1994).

[44] In the case of a donation to a nonprofit corporation impressed with a trust, the normal trust rules summarized above apply. Moreover, as mentioned above, some states, by statute or court decision, deem corporate charities to hold their assets in trust, subject to that regime. See, e.g., Section 5820 of the California Nonprofit Corporation Law: "Amendment of the articles of a corporation . . . does not, of itself, abrogate any requirement or limitation imposed upon the corporation, or any property held by it, by virtue of the trust under which such property is held by the corporation." Subsection (b) provides: "The Attorney General may, at the corporation's request, and pursuant to such regulations as the Attorney General may issue, give rulings as to whether the Attorney General will or may oppose a proposed action, or article amendment, as inconsistent with or proscribed by the requirements of a charitable trust." *See also* Pacific Home v. County of Los Angeles, 264 P.2d 539, 544 (Cal. 1953) ("If plaintiff were to . . . amend its articles [to permit a noncharitable purpose], such action would not affect the trust status of property theretofore acquired. Such property, which was acquired when plaintiff's articles were limited to charitable purposes, was thereby impressed with a trust for such purposes, and if such property subsequently should be diverted to newly-declared nonexempt purposes, the attorney general would have the duty to bring appropriate proceedings to enforce the trust.").

corporation could not amend its articles to adopt new purposes for future activities and gifts. However, the court accepted the view that pre-amendment unrestricted gifts may not be used for the new purpose, a result subsequently adopted by statute.[45]

II. Roles of the Players

A. Issue of Standing for Donors and Other Private Parties

The attorney general, co-trustees, and persons with a "special interest" may enforce the terms of a charitable trust or a restricted gift. Traditionally, the settlor may sue only if he or she had retained a right of reverter, and thus a claim adverse to the interests of the charity.[46]

By contrast, the new Uniform Trust Code provides standing for the settlor of a charitable trust both to enforce the trust and to seek modification.[47] Distinguish enforcement of the restriction from recovery of the property. Indeed, the Uniform Trust Code makes it harder for the gift to return to private hands by relaxing the traditional prerequisite to cy pres modification that the donor had a "general charitable intent."[48]

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[45] Attorney General v. Hahnemann Hospital, 494 N.E.2d 1011 (Mass. 1986). See, too, the description of New York law in the attorney general office's description of its obligation to: "Assure that where the charity's new purposes do not overlap with its original purposes, the charitable assets obtained by a charity for its original corporate purpose continue to be used for that restricted purpose, pursuant to the doctrine of cy pres (the subject of the 1985 Court of Appeals decision in Alco Gravure v. Knapp Foundation, 64 N.Y.2d 458 (1985))." *The Regulatory Role of the Attorney General's Charities Bureau*, by assistant attorneys general Nathan M. Courtney and James G. Siegal, Charities Bureau, New York State Attorney General (no date), *available at* <http://www.oag.state.ny.us/charities/charities.html>.

[46] Section 391 (Who Can Enforce a Charitable Trust?) of the *Restatement (Second) of Trusts* provides: "A suit can be maintained for the enforcement of a charitable trust by the Attorney General or other public officer, or by a co-trustee, or by a person who has a special interest in the enforcement of the charitable trust, but not by persons who have no special interest or by the settlors or his heirs, personal representatives or next of kin." Coverage of this issue in the *Restatement (Third) of Trusts* is in progress.

[47] As to enforcement, Section 405(c) of the Uniform Trust Code provides: "The settlor of a charitable trust, among others, may maintain a proceeding to enforce the trust." As to modification, the last sentence of Section 410(b) of the new Uniform Trust Code states: "The settlor of a charitable trust may maintain a proceeding to modify the trust under Section 413." Commentary provides: "Contrary to Restatement (Second) of Trusts § 391 (1959), subsection (b) grants a settlor standing to petition the court under Section 413 to apply cy pres to modify the settlors' charitable trust."

Separately, the Connecticut Supreme Court held that UMIFA does not give a donor standing to bring a lawsuit in a case where the charity altered the restriction over the objection of the donor. Carl J. Herzog Foundation, Inc. v. University of Bridgeport, 699 A.2d 995 (Conn. 1997). The UMIFA revision project is not addressing the issue of donor standing.

[48] Moreover, concerned about the possibility of a windfall reverter many years later, Section 412(b) of the Uniform Trust Code provides: "(b) The power of the court under subsection (a) to apply cy pres to modify or terminate a charitable trust is subject to a contrary provision in the terms of the trust that would result in distribution

Even without statutory authority, two recent New York appellate cases (in split decisions) granted standing to donors, although a third rejected it.[49] Notably, in *Smithers v. St. Luke's-Roosevelt Hospital Center*,[50] an appellate court granted standing to a donor's widow – as a court-appointed representative of her husband's estate – to challenge the new use of his restricted gift, despite an alternative arrangement proposed by the donee charity and approved by the attorney general.[51] The three-judge majority opinion declared: "We conclude that the distinct but related interests of the donor and the Attorney General are best served by continuing to accord standing to donors to enforce the terms of their own gifts concurrent with the Attorney General's standing to enforce such gifts on behalf of the beneficiaries thereof." The dissent worried that: "By determining that the plaintiff may pursue the instant action, the majority necessarily concludes that a decedent's estate, which has no interest in a gift, may prevent the New York State Attorney General from exercising his discretion in determining how to prosecute alleged violations of the law." The matter settled in September 2003.[52]

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of the trust property to a noncharitable beneficiary only if fewer than 21 years have elapsed since the date of the trust's creation." One commentator observes: "Apparently, the drafters have left to local law the case of when a gift over is charitable, no matter how many years have elapsed since trust creation. An attempt in earlier drafts of the UTC to deal with the effect on *cy pres* of a charitable gift over was stricken in the final draft." Ronald Chester, *Modification and Termination of Trusts in the 21st Century: The Uniform Trust Code Leads a Quiet Revolution*, 35 REAL PROP., PROB. & TR. J 697, 708 (2001) (footnote omitted).

[49] Marcus v. Jewish National Fund, 557 N.Y.S.2d 886, 889 (N.Y. App. Div. 1990), allowed suit for false charitable solicitation brought by a group of supporters of Israel – defined as augmented by settlements in territories acquired after the Six-Day War. The defendant charity's fund-raising material uses a map of Israel that includes the territories, although in fact the charity intends to spend (and for the last twenty years has only spent) donated funds in territory within the pre-War "Green Line." The dissent asserted: "[T]he defendant has no obligation to use its funds other than in accordance with its charter. There is no contention that the funds are not used for a purpose for which the defendant is organized. Plaintiffs would have the defendant cover all bases while the defendant is satisfied to cover only a portion thereof. Plaintiffs are not deceived, rather they are unsatisfied."

In contrast see *In the Matter of Alaimo*: "Respondent, decedent's grandson and a person in whose honor the trust was created, lacks standing to challenge petitioners' administration of the trust [citations]. Rather, standing to enforce the trust or challenge petitioners' administration of it is restricted to the Attorney General." 732 N.Y.S.2d 819 (N.Y. App. Div. 2001).

[50] 281 A.D.2d 127 (N.Y. App. Div. 2001).

[51] The New York surrogate court subsequently granted attorneys fees to Mrs. Smithers-Fornaci out of her husband's estate, over the opposition of the attorney general and several charitable remainder beneficiaries. Accounting by Henry S. Ziegler as Executor of the Last Will and Testament of Dec. No. 274 R. Brinkley Smithers, 760 N.Y.S.2d 304 (Surr. Ct. 2003). The court concluded: "To deny this court the right to award reasonable counsel fees to this fiduciary would vitiate the right of a private cause of action created by the Appellate Division. Of course, the fiduciary does not possess a blank check to frolic far afield from her duties to the estate. The court never loses the right to examine a request for attorney's fees and each case must be decided on the unique facts presented . . . ."

[52] The settlement document has not been made public, and reports of its terms vary. The agreement requires St. Luke's-Roosevelt Hospital to transfer either $6 million (according to the New York *Sun*) or $8 million (according to the *Daily News*) either to the estate of R. Brinkley Smithers (according to the *Sun*) or to another charity for the original purpose (according to the *Chronicle of Philanthropy*). *See* Adam Cataldo, *St. Luke's-Roosevelt Settles Smithers Suit*, NEW YORK SUN, Oct. 23, 2003, at 2; William Sherman, *Rehab Center on Mend with $8M*

In a case involving the enforcement of a trust for a chair at the University of Georgia, the donors were unsuccessful in obtaining standing based on their assertion that the attorney general, who also represented the defendant board of regents, had a conflict of interest. The court concluded that "the remedy for a conflict of interest is to involve the district attorney or appoint a Special Assistant Attorney General. Such a conflict certainly would not mandate that persons with no 'special interest' (such as plaintiffs here) would be granted standing to enforce a charitable trust."[53]

A small, but significant trend is developing in which donors, or their heirs or representatives, have been invoking contract doctrine to force charities that breach gift restrictions to either return the funds to the donor or to transfer them to another charity.[54] Recently, a court applied contract law to allow a reverter suit even without such a right reserved in the gift instrument.[55] In the unpublished California appellate court decision in *Glenn v. University of Southern California*, the donor and the charity disputed whether the transaction was a gift or a contract. The parties – and the court – assumed that if the transaction were a gift, the donor would have not standing to sue to enforce its terms, but if the transaction were a contract,

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Settlement, DAILY NEWS, Oct. 22, 2003, at 55. Smithers' original gift was $10 million, which the hospital spent for a residential rehabilitation facility that it sold for more than $14; Stephen G. Green, N.Y. *Hospital Settles Case Filed by Donor's Widow*, CHRONICLE OF PHILANTHROPY, Oct. 30, 2003, at 14. The hospital is obligated to use the remainder of the sale proceeds for its substance-abuse programs, but the hospital may no longer use the Smithers name. *See also* Tina Susman, *Gift-Givers Keeping Closer Tabs*, [NEW YORK] NEWSDAY, Oct. 24, 2003, at A26.

53 Warren v. Board of Regents, 544 S.E.2d 190 (Ga. App. 2001).

54 See Ronald Chester, *Grantor Standing to Enforce Charitable Transfers Under Section 405(c) of the Uniform Trust Code and Related Law: How Important Is It and How Extensive Should It Be?*, 37 REAL PROP., PROB. & TR. J. 611 (Winter 2003) (endorsing donor standing – but not standing for the donor's heirs – when the gift constitutes a contract). Professor Chester would only allow the grantor to sue for compliance with the restricted use, "or if specific performance is impracticable because of misappropriation of all or part of the gift, the grantor can sue for damages to restore the gift to its appropriate size . . . ." *Id.* at 634.

55 Stock v. Augsburg College, 2002 Minn. App. LEXIS 421 (Apr. 16, 2002) (unpublished). In this case, the appellate court ruled that where a college "promised to name the wing after appellant in exchange for appellant's $500,000 donation," "a cause of action for breach of contract accrued to appellant when the building was completed and the entire building named without any mention of appellant." However, "because appellant did not bring suit within six years after respondent's breach of contract, we agree with the district court that his contract claim was time-barred." Dicta made clear that the court would have enforced the college's promise, and enforced a repayment of the gift with other funds: "Nonprofit corporations, for-profit corporations, and individuals, are expected to honor their commitments. Courts of law and equity enforce legal contracts. Had appellant timely sued, no harm would come to Augsburg, specifically, or society in general, if just debts were paid. The keeping of one's promise honors us all."

See also the news reports of the dispute between David Mugar and Boston University over the failure of BU to spend donated funds for the specified purpose of renovating the library funded by his parents. As reported in the press, Mugar demanded, and BU agreed, that the amount of the gift would be transferred to other charities with which Mugar is affiliated. *See, e.g.*, Patrick Healy, *Mugar Threatens BU with Suit on "Lost" $3M*, BOSTON GLOBE, Dec. 11, 2002; Patrick Healy, *BU Agrees to Give $3M from Mugar to Charities*, BOSTON GLOBE, Dec. 18, 2002, at A1.

the donor would have standing under ordinary contract doctrine.[56] In reviewing concluded or pending cases, the *New York Times* observed that donors' "muscle philanthropy" will "almost certainly increase the institutions' costs, not only to defend themselves but also to improve internal financial controls."[57]

The traditional view is that a restricted gift is not a contract. Instead, if it becomes burdensome for the charity to perform the restriction, the court will modify the restriction under the cy pres doctrine rather than hold the charity to the benefit of the bargain. See, for example, *Knights of Equity Memorial Scholarships Commission v. University of Detroit*,[58] which involved a 1924 donation that funded in full 24 scholarships into perpetuity. The court took judicial notice of "the shrinkage in the value of the dollar, of the hardships visited upon the recipients of fixed incomes," and the necessity that "the suit must be cut to fit the cloth." For several years, the university made up the shortfall between the cost of tuition and the income of the fund out of its other assets, but finally "contended that the intention of the parties in the agreement was not to impose a financial burden upon the school." (The school also argued "that if this were to be held an ordinary contract, the doctrine of commercial frustration would apply to it.") The Michigan supreme court found: "The circumstances surrounding the transaction and the expressed intent of the parties, as well as the time of agreement itself, reject any conclusion that this was purely a contract or that it should be so construed." In affirming the decision of the chancellor that the scholarships should function only as a credit against tuition, the court commented: "should such inflexibility in the use of trust funds become the rule, a curtailment of the facilities otherwise available to all must be the inevitable result. It is to this situation that the cy pres doctrine has particular applicability."[59]

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[56] In Glenn v. University of Southern California, B151776, 2002 Cal. App. Unpub. LEXIS 8508 (Cal. App. 2002), the appellate court, reversing the trial court, held that the donor is entitled to a trial on his claims of breach of contract. The court rejected the university's argument that the oral terms would necessarily be inadmissible. The appeals court also permitted the donor to prosecute his claim of promissory fraud. Finally, the court allowed Glenn to proceed with his claims of common law and statutory misappropriation. See also Stephen G. Greene, *Seeking Control in Court: Disgruntled Donors Sue Over Use of Their Gifts*, CHRON. PHILANTHROPY, Nov. 28, 2002 (discussing *Glenn*; the Searle lawsuit against the Chicago Community Trust; and the Robertson family suit against Princeton University over the Woodrow Wilson School).

[57] Stephanie Strom, *Donors Add Watchdog Role to Relations With Charities*, N.Y. TIMES, Mar. 29, 2003, at A8. The story quotes Janet P. Atkins, chief executive of Philanthropic Advisers, a consulting firm: "We have constructed some really hairy gift agreements recently. . . . Donors are asking for serious accountability and spelling their terms out in great detail."

[58] 102 N.W.2d 463 (Mich. 1960).

[59] In so ruling, the court explicitly rejected the reasoning in two Pennsylvania supreme court decisions. In the first, Alumnae Association v. University of Pennsylvania, 159 A. 449 (Pa. 1932), in which the donation obligated the recipient to provide hospital services, the court declared: "Assuming that the defendant hospital authorities were at liberty to reject the endowment at the time of the merger of the two hospitals, they did not do so, but, in terms not in the slightest degree doubtful, accepted the endowment and have for sixteen years continuously carried out the terms of the contract without questions. They cannot now be permitted to repudiate it." In the second, Hopkins v. Women's Medical College of Pennsylvania, 200 A. 32 (Pa. 1938), involving full scholarships, the court declared: "If

Separately, a recent trend that bears watching is the use of "trust protectors" in the administration and enforcement of private trusts, and how this might play out in the charitable trust context. The *Restatement (Third) of Trusts* views such third parties, regardless of their designation in the gift instrument, as subject to the responsibilities and liabilities of fiduciaries.

Finally, the presence of a "gift over" traditionally defeats a finding of general charitable intent, and thus the application of cy pres. However, courts do not universally accept that a gift over negates the current charity's ability to seek deviation or cy pres relief.[60] The better approach to take in cases like this could be to liberally construe situations in which the doctrine of deviation rather than cy pres might be applied, and then to defeat application of the gift over only in cases of deviation.[61]

B. Role of the Charity

When it carries out a restriction, the governing board will often have to exercise some level of discretion in construing donor intent.[62] For example, the gifts by Sybil Harrington to the Metropolitan Opera require the Met to spend the money on "traditional" opera.[63] But as one art critic observed, "'Traditional' is a slippery word. . . . The Met's venerable version of Wagner's 'Ring,' beloved by some as an insight into what Wagner really wanted, looks to me more like what venerable donors might have seen in their childhood in the 1930's."[64]

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conditions subsequently demonstrated the College, in its natural eagerness to secure substantial contributions, had made an unwise bargain, that, of course, would not relieve it from performance. . . . If respondent's viewpoint were to be upheld, the raising of the tuition rates would be permitted to defeat the entire object of petitioners by making their gift hopelessly inadequate for the purpose for which, in good faith, it had been contributed."

[60] *See generally* Ronald Chester, *Cy Pres or Gift Over: The Search for Coherence in Judicial Reform of Failed Charitable Trusts*, 23 SUFFOLK U. L. REV. 41 (1989).

[61] In the deviation context, see Trustees of Dartmouth College v. Quincy, 258 N.E.2d 745, 753 (Mass. 1970), discussed in Part II, above. In the cy pres context, see Home for Incurables of Baltimore City v. University of Maryland Medical System Corporation, 797 A.2d 746 (Md. 2002), where the Maryland Court of Appeals voided a whites-only restriction in a gift to a nursing home (Keswick) on the grounds of illegality, thus defeating the suit by the alternate beneficiary, the University of Maryland (which was not burdened by a discriminatory restriction).

[62] But see the troubling case of Freme v. Maher, 480 A.2d 783 (Me. 1984), in which the board of a bankrupt college decided to convert the Knox Trust into a scholarship program. The trial court had applied cy pres to transfer the Trust assets to three liberal arts colleges in Maine (Bates, Bowdoin and Colby Colleges). The high court of Maine reversed, and upheld the trustees' application of the funds to scholarships. Because "the Knox will does not suggest a clear attachment to Ricker, the college, as opposed to Ricker, the corporation," and because the corporate existence of Ricker College will continue, the court concluded "that the trust does not fail, and the doctrine of cy pres need not be applied, based upon any want of a qualified, existing beneficiary."

[63] See the petition in Amarillo Area Foundation v. Metropolitan Opera Association, Inc., Cause No. 91214-A (Potter County, Texas, July 22, 2003).

[64] John Rockwell, *In Defense of Willful Directors*, N.Y. TIMES, Aug. 24, 3003, § 2, at 4. Of the offending

In assessing the charity's performance in complying with gift restrictions, the ordinary standard of prudence and care, carried out in good faith, applies. As in other situations involving performance of legal duties, a charity might informally consult with the state attorney general's office for guidance, and may seek instruction from the court.[65] Ultimately, it may be necessary for the restriction to be modified. In such a case, if the gift instrument provides a mechanism for modifying a restriction, the charity seeking to terminate or modify the restriction must follow that procedure.[66] If the gift instrument does not provide the desired relief, the charity may obtain release of the restriction to the extent provided in UMIFA. In any case, the charity may petition the court to modify the restriction, but the standards for relief might be more constrained.[67]

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production that was the subject of a recent suit, another observer wrote: "There is no doubt that Mrs Harrington would have disapproved: her predilections were for Zeffirelli-style realism and lavish period frocks, even when these ran contrary to 'the intentions of the composer' – in his memoirs, director John Dexter recalls how she complained when a proposed production of La Traviata made Violetta end up looking as poor as the libretto states she is. Mrs Harrington thought this was "too sad" and refused to give money to anything so unpleasant." Rupert Christiansen, *The Cost of Going Modern*, [LONDON] DAILY TELEGRAPH, July 30, 2003, at 19.

[65] But see the an eyebrow-raising saga of the B.F. Ferguson Monument Fund and the Art Institute of Chicago. To simplify, in 1905 Ferguson devised $1 million to the B.F. Ferguson Monument Fund, the net income from which was to be paid annually to the Art Institute "entirely and exclusively [to be] used and expended by it under the direction of its Board of Trustees in the erection and maintenance of enduring statuary and monuments . . . in the parks, along the boulevards, or in other public places" in the city of Chicago, "commemorating worthy men or women of America, or important events in American history." For the next 25 years the Art Institute commissioned noteworthy public statues, bridge houses, and a fountain. Then the Art Institute undertook a project to expand its facilities. In 1933 the Art Institute obtained a decree construing the word "monument" to include a memorial building, and authorizing the Art Institute to spend Fund moneys on its own building expansion program. *See* Art Institute of Chicago v. Castle, 133 N.E.2d 748, 750 (Ill. App. 1956). By 1955 the Art Institute was ready to build, and returned to court to confirm its plan to construct an administrative wing. *Id.* (also in this proceeding, the National Sculpture Society lost its bid to intervene). *See also* Greene v. Art Institute of Chicago, 147 N.E.2d 415 (Ill. App. 1958) (dismissing taxpayer's complaint for lack of standing).

As the attorney for the plaintiff denied standing later described the 1933 proceeding: "[I]t was subsequently discovered that the Art Institute's Complaint, the Attorney General's Answer, and the court's Decree were all typed on the same typewriter, all bore the same watermark, and the Attorney General's Answer was enclosed in the reversed blue backing of the Art Institute's counsel. . . *, who was himself a member of the Art Institute's Board*." Luis Kutner, *The Desecration of the Ferguson Monument Trust: The Need for Watchdog Legislation*, 12 DE PAUL L. REV. 217, 219-220 (1962-63) (emphasis in original). In an addendum, this article noted that the new attorney general re-examined the case, and that the Art Institute of Chicago agreed that the accumulated income from the $1 million principal of the Ferguson Monument Fund would be used to erect statuary in Chicago. *Id.* Kutner does not comment on how "accumulated income" was computed.

[66] As described in commentary to the *Restatement (Third) of Trusts*: "A trust provision expressing the settlor's own choice of an alternative charitable purpose will be carried out, without need to apply the cy pres doctrine, assuming not only that the initially specified purpose cannot be given effect or continued but also that the alternative purpose is one that properly can be given effect." *Restatement (Third) of Trusts*, § 67, Comment *b*.

[67] As a general principle, it would be socially desirable if restrictions on small funds can be modified, when necessary, by the governing board without resort to expensive litigation. See, for example, § 414(a) of the Uniform Trust Code: "After notice to the qualified beneficiaries, the trustee of a trust consisting of trust property having a total value less than [$50,000] may terminate the trust if the trustee concludes that the value of the trust property is

Comment *d* to § 67 of the *Restatement (Third) of Trusts* observes that normally it is the trustees (or attorney general) who apply to the court seeking court modification of the restriction. Comment *f* to § 399 of the *Restatement (Second) of Trusts* declares that the consent of the trustees to application of cy pres is not necessary, but concludes that the "court will usually give weight to the wishes of the trustees." Accordingly, usually the charity in the first instance crafts a new scheme for applying the restricted property. However, the attorney general and courts have an obligation to enforce fiduciary duties, so, in the appropriate case, the restriction may be modified without the consent of the charity fiduciaries or over their objection.[68]

C. Roles of the Attorney General and Courts

The state attorneys general and courts have the responsibility to guard against charity fiduciaries' wrongdoing, and to enforce charitable obligations without interfering in decision-making carried out in good faith.[69] The attorney general is vested with the authority to seek to

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insufficient to justify the cost of administration." If the instrument and state statute do not provide appropriate relief, the attorney general and court should look upon such petitions with favor.

[68] As two recent state supreme court cases illustrate, termination of a trust requires the participation of the trustees, but the trustees do not have unlimited discretion. In Leone Hall Price Foundation v. Baker, 577 S.E.2d 779, 781-82 (Ga. 2003), the Georgia supreme court ruled: "The trustee must have a voice in whether to take [the] ultimate step [of complete dissolution], because he has a general duty to prevent destruction of the trust" even when "the Attorney General and Revenue Commissioner represent the beneficiaries of the Foundation in seeking an end to the trust." In In re R.B. Plummer Memorial Loan Fund Trust v. State of Nebraska, 661 N.W.2d 307 (Neb. 2003), the Nebraska supreme court refused to grant a cy petition to convert two student loan funds into scholarship funds, because the "the record does not support a conclusion that their purposes have been made impracticable": "The Foundation pled that because of changes in the financial aid arena, students are reluctant to pursue loans from multiple sources because federal loans are available at competitive rates. . . . The record . . . shows that the Foundation can change the loan terms to make them more desirable." *Id.* at 312. The court rejected the foundation's alternative argument that this is a matter of administration rather than purpose, and thus that the test of deviation rather than cy pres should apply.

[69] For a discussion of the powers of courts over charity fiduciaries, see EDITH L FISCH, CHARITIES AND CHARITABLE FOUNDATIONS § 712, at 549-50 (1974); FISHMAN AND SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 255-56 (2d ed. 2000). For additional discussion of the roles of charity law enforcers (attorneys general and the Internal Revenue Service) and the courts, see Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873 (1997); Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD L. REV. 1400 (1998); Evelyn Brody, *A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L. REV. 537 (1999) (Bishop Estate Symposium Issue); and Evelyn Brody, *The Legal Framework for Nonprofit Organizations*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK (Walter W. Powell & Richard Steinberg, eds., 2d ed., forthcoming).

The first known application of the criminal laws to a breach of a restricted charity gift involving no self-dealing concluded in 2002. On the civil side, the Pennsylvania attorney general obtained a $94 million settlement (funded largely by D&O insurance) of civil claims due to breaches of fiduciary duty by executives of the Allegheny Health, Education and Research Foundation ("AHERF"), the largest health care bankruptcy in the country. The attorney general prosecuted the chief executive officer, the chief financial officer, and the general counsel for hundreds of charges of "misapplication of entrusted funds" for spending endowment and restricted gifts on operations. A court dismissed the charges against the CFO and general counsel, and accepted a guilty plea for a correct breaches of charity responsibilities and of fiduciary duty that have not otherwise been remedied by the board, but the attorney general is not a "super" member of the board.[70] The courts are needed to guard against possible opportunism by the charity's fiduciaries, but also have no particular familiarity with the charity's operating needs.

In a suit to modify a charitable restriction, courts ordinarily defer to the fiduciaries when the attorney general has no objection.[71] However, courts are not bound by a settlement reached between the attorney general and the charity.[72] Availability of court review can curb inappropriate regulator zeal – or willingness to compromise – but even a process of court review still risks error by both the enforcer and the tribunal.

In sum, "[a] court will not interfere with a trustee's exercise of a discretionary power when that exercise is reasonable and not based on an improper interpretation of the terms of the trust."[73] Should the attorney general contest the charity's proposal or should the charity balk at an attorney general demand, the court might appoint a master.[74] Moreover, if the court has

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single count of misapplication from the CEO, who served several months in a work-release program.

[70] New York has a statute providing: "The attorney general shall represent the beneficiaries of . . . dispositions [of property] for religious, charitable, educational or benevolent purposes and it shall be his duty to enforce the rights of such beneficiaries by appropriate proceedings in the courts." NY EPTL § 8-8.1(f). In Lefkowitz v. Lebensfeld, 417 N.Y.S.2d 715, 720 (App. Div. 1979), *aff'd*, 415 N.E.2d 919 (N.Y. 1980), the appellate division observed that where a restricted gift is made to a charitable corporation, the attorney general has standing to enforce that restriction. By contrast, "a donor who has attached no conditions has no such expectation. He is, in effect, relying on the good will and judgment of the donee charity to utilize his gift in what the donee perceives to be the most appropriate manner." Instead, the attorney general may, if warranted, proceed against the fiduciaries.

[71] See, for example, In Re Barnes Foundation; Estate Of: Violette De Mazia, 684 A.2d 123, 136 (Pa. Super. 1996).

[72] *See, e.g.,* In the Matter of the Trust under the Will of Caroline Weld Fuller, 636 N.E.2d 1333 (Mass. 1994).

[73] *Restatement (Third) of Trusts*, § 50, Comment *b*. "The line of demarcation at which point the courts will interfere with the discretion of those governing a public charity reasonably is the point of substantial departure by the governors (or Board) from the dominant purpose of the charity, and, unless the directors so administer it that there is such a *substantial departure from the charity's dominant purpose* as to amount to a perversion of it the court will not interfere." Taylor v. Baldwin, 247 S.W.2d 741, 750 (Mo. 1952) (emphasis in original). Permitting the board of a hospital to sell a facility provided by a restricted gift, relocate, and affiliate with Washington University, the court applied deviation, not cy pres, because the "differences between the parties to this action actually concern only the administrative details of the operation of the charity." *Id.* at 756. Note that the attorney general withdraw his charge against the trustees of the charitable trust, stating that he "does not wish to pursue his prayer for the removal of the defendant trustees, the good faith of whom has never been drawn in issue." *Id.* at 756-57 (quoting the attorney general's reply brief).

[74] As described in the *Restatement (Third) of Trusts*, § 67, Comment *d*, at 517: "The cy pres power is vested in the court, not in the trustee or the Attorney General, who is, however, a necessary party entitled to notice of the proceeding. . . . In its effort to select a substitute purpose, the court may refer the matter to a master, who, after

concerns about possible conflicts of interest or lack of independence, the court can appoint special-purpose trustees to make a recommendation.

Parochialism is a particular concern in state charity law enforcement.[75] Attorneys general commonly administer the law by assuming that donors to an existing charity means those funds to "stick" to that community; courts (and legislatures) often agree. However, a community in which charity operations occur is not necessarily congruent with the donor's conception of the beneficiary class. Moreover, state-level rivalry can harm other states, and intra-state moves usually provoke protests from the incumbent community. When attorneys general act parochially, no state regulator exists whose interest it is to look out for the beneficiaries of a national or international charity.

Multi-state hospital systems vividly illustrate the enforcement issues. For a dramatic example, consider the events following the bid by a for-profit hospital chain to acquire the assets of nonprofit Health Midwest, the largest health system in the Kansas City area – and one that straddles two states. The fight quickly began over control of an expected $700 million of sale proceeds, which would be paid to one or more "conversion foundations." When Health Midwest brought suit to clarify the jurisdiction of the attorneys general of Missouri and Kansas, both attorneys general responded by suing to remove the Health Midwest board for abandonment of charitable purpose.[76] This is a misuse of attorney general power: Seeking court instruction is part of the proper exercise of a governing board's duty.[77]

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receiving evidence as well as suggestions from interested parties, will frame an alternative plan or two and submit a recommendation or recommendations to the court." The traditional approach appears to take no account of the charity's thoughts on the matter. As declared by the court in Brookline v. Barnes, 97 N.E.2d 651, 655 (Mass. 1951): "The application of funds *cy pres* is a judicial function, and this court may remand a case for the framing of such a scheme . . . , may frame a scheme itself . . . , may choose between various schemes reported by a master, accepting the one it deems best. . . , or may accept the general scheme recommended by the master with such modifications as it deems necessary. . . ."

[75] For a discussion of state parochialism in cases involving the Terra Foundation (Illinois), the Hershey Trust (Pennsylvania), and Health Midwest (Missouri and Kansas), see Evelyn Brody, "Whose Public? Parochialism and Paternalism in State Charity Law Enforcement" (Sept. 2003 draft). *See also* Michael W. Peregrine & James R. Schwartz, *Key Nonprofit Corporate Law Developments in 2001*, 11 HEALTH LAW REPORTER 272 (February 14, 2002) (discussing three 2001 settlements: in Florida (with Intracoastal Health Systems), in Illinois (Terra Museum), and in Minnesota (Allina Health Systems)).

[76] In the Fall of 2002, for-profit bidder HCA, Inc. submitted a winning bid of $1.125 billion to acquire Health Midwest. The matter was settled when Health Midwest agreed to use the proceeds to fund two separate conversion foundations, one in each state and each operating under extraordinary attorney general supervision. For the unreported lower court decision, see Health Midwest v. Kline, No. 02-CV-08043, slip op. (Johnson County, Kansas, Feb. 3, 2003).

[77] In Holden Hospital Corp. v. Southern Illinois Hospital Corp., 174 N.E.2d 793, 797 (Ill. 1961), the court also considered the trial court's finding that "the directors of Holden had 'abused their discretion' in attempting to sell its assets, and [ordering] that Holden should continue to operate the hospital, subject to the jurisdiction of the court": "It is hard to see how, on any theory, the directors' discretion was so narrow as to forbid them to formulate a

Recent administration of the Hershey School Trust provides additional object lessons of how all three branches of state government – the attorney general, the courts, and the legislature – can misconceive their role. Events began with the Hershey Trust's unsuccessful 1999 cy pres petition.[78] The Hershey Trust faced a classic case of surplus: It found that its income from the Hershey Foods Corporation stock far exceeded its ability to spend on students at the Milton Hershey School, established originally for poor, white, male orphans. (All three of these last restrictions had been relaxed in earlier cy pres proceedings.) Despite spending generously to provide students with education, housing, food, and clothing, the School Trust had an accumulated surplus of $600 million on an investment base of several billion dollars. The 1999 application sought to spend $25 million a year out of accumulated and current income on an institute to train teachers in educating at-risk children, to be known as the Catherine Hershey Institute for Learning Development (CHILD).[79] The Hershey School attempted to demonstrate that it could prudently continue the donor's original program; that it would not be prudent either to spend additional amounts per child at the school or to expand the school; and that the new institute is reasonably related to the donor's charitable purpose. The attorney general, who had initially supported the petition, took the position in court that there was no failure of the trust. The court ruled that "[a]ny discretion of the Board of Managers is servient to the dominant intent of the Hersheys to care for as many children at the School as the income will permit." The court distinguished a successful 1963 cy pres proceeding – in which funds were permitted to be spent on a medical school – by noting the attorney general's support of that earlier petition, and the absence of public notice, hearing and opinion in that matter. In conclusion, "our [cy pres] discretion is not unfettered and, if exercised, must be within the limits of approximating the dominant intent of the Hersheys. The proposed Institute does not even come close." The court also rejected the application of deviation, holding that the desired change was to purpose, not to administration.

More recently, the Hershey School Trust unsuccessfully sought to diversify its assets. In order to preserve local control of a publicly traded company located in Hershey, Pennsylvania, the Pennsylvania attorney general sued for an injunction to prevent the Hershey School from divesting an investment in Hershey Foods Corporation worth over $5 billion. The trust instrument lacked any declaration of a charitable purpose to benefit the town of Hershey. Nevertheless, in a September 2002 proceeding, the same judge who rejected the 1999 cy pres proceeding ridiculed the Trust's desire to protect and enhance its investment portfolio by

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plan which might take effect only upon approval by a court. . . . It would be a strange reward for their caution if they are on that account to be deprived of control of their enterprise." 174 N.E.2d at 796-97.

[78] Milton Hershey School, et al., Dauph. C.C.P. No. 712, year of 1963, Slip Op. (Dec. 7, 1999) (Judge Warren G. Morgan), *available at* <http://www.miltonhersheyschool.com/mhsaa/Lib/Adjudication%20and%20Decree%20-%20Dec%207%201999.pdf>.

[79] *See* Reply Brief of Milton Hershey School and Hershey Trust Company to Brief of the Office of Attorney General, Oct. 21, 1999, *available at* <http://www.miltonhersheyschool.com/mhsaa/Lib/Reply%20Brief%20-%20Oct%2021%201999.pdf>.

essentially observing that the Trust can't even spend the money it already has.[80] Indeed, by 2002, reportedly spending "$93,000 a year to educate, house, clothe, feed and nurture each of its 1,200 students, the school still has a reserve fund of more than $850 million from all the money it could not spend over the years."[81]

In granting a preliminary injunction against the stock sale, the Orphans' Court began its discussion by ruling that "[p]roperty given to a charity is in a measure public property," and that "the Attorney General has the authority to inquire whether an exercise of a trustee's power, even if authorized under the trust instrument, in inimical to the public interest." The Commonwealth Court affirmed the grant of a preliminary injunction, and ordered an expeditious hearing.[82] However, on September 17, 2002, the night before the Commonwealth Court ruled, the Trust succumbed to overwhelming public pressure and voted ten to seven to reject a purchase offer from gum manufacturer Wm. R. Wrigley, Jr. Co., totaling $12.5 billion in stock and cash (as well as a promise to maintain jobs in the Hershey community), and abandoned its plans to sell its stock.

The denouement took the form of three events in November. On November 5, the attorney general was defeated in the race for governor. On November 6, the governor signed a bill that would require the trust to obtain court approval, with attorney general and community input, before reconsidering a sale.[83] Paragraph (c)(6) directs a fiduciary in making and managing investment decisions, to consider: "An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries, including, in the case of a charitable trust, the special relationship of the asset and its economic impact as a principal business enterprise on the community in which the beneficiary of the trust is located and the special value

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[80] Referring to the Trust's expert witness, the court declared: "this same consultant, having stated that his investment objective is to make enough money to support the School's current and prospective educational program in perpetuity at a reasonable level of risk, admitted on cross-examination that he had never known the Milton Hershey School not to have enough money to do what it needs to do." Decree and Adjudication, In re Milton Hershey School Trust, *reprinted in* 807 A.2d 324 (Pa. Commw. Ct. 2002).

[81] Steven Pearlstein, *A Bitter Feud Erupts Over Hershey Plant; Plan to Sell Candy Empire Divides a Company Town*, WASH. POST, Sept. 2, 2002, at A1.

[82] In re: Milton Hershey School Trust, 807 A.2d 324 (Pa. Commw. 2002). The lone dissenting judge "disagree[d] that the Attorney General has authority to become fully involved under a parens patriae theory to protect the 'public' regarding the proposed sale" prior to a decision by the trustees to sell. "If that were the case, then the Attorney General could become fully involved in the decision-making process of every charitable trust or, for that matter, every charity in Pennsylvania." Nowhere in the Probate, Estate and Fiduciaries Code, he wrote, "is there any authority for the Attorney General to essentially act as co-trustee or comanager of the Trust and be part of the process leading up to a decision by the Trustees to take a certain action." In sum, "[a]bsent a showing that the Trustee's actions are against the terms of the Trust or that the Trust provisions themselves are against public interest, the parens patriae powers of the Attorney General do not apply."

[83] See H.B. 2060, *available in* LEXIS, States Library, PATEXT file, as 2001 PA H.B. 2060, amending section 7203 (Prudent Investor Rule) of Title 20 of the Pennsylvania Consolidated Statutes.

of the integration of the beneficiary's activities with the community where that asset is located." Finally, on November 14, ten of the Trustees (including all seven who voted in favor of the Wrigley bid) resigned, and four new members (including a former Pennsylvania attorney general) were appointed, leaving the board with a majority of local members.[84]

III. Foreign Charities: Nexus/Situs, Conflict of Laws, and Jurisdiction

An issue of growing importance is the role of state law and enforcement when the charity forms in one state but operates across state lines. Even for charities intending to operate in a single state, the desire to operate free of unreasonable governmental oversight has led savvy advisers to choose the state of formation and administration carefully. While their laws tend to resemble each other, states sometimes have different policy goals, or compete with each other by providing more hospitable legal environments for certain activities.

A matter may be heard in one jurisdiction while applying the law of another. The law is generally settled for charitable trusts: Unless the trust designates a jurisdiction, issues of interpretion are governed by the law of the state of organization and issues of administration are

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[84] Compare the pending petition of the Barnes Foundation to move its celebrated collection of Impressionist art to downtown Philadelphia. Albert Barnes established the Barnes Foundation to receive, maintain and operate a world-class collection of Impressionist art in a residential suburb of Philadelphia. (While the Barnes Foundation is a corporation, the detailed restrictions imposed on the donated collection, including those relating to maintenance and operation, appear in a trust instrument. Commonwealth v. Barnes Foundation, 159 A.2d 500, 502 (Pa. 1960).) The Barnes Foundation, which has long struggled to remain financially viable, faces bankruptcy if it must continue to operate under these restrictions. In September 2002, the Foundation approved a plan to accept the offer of the Pew Charitable Trusts and the Lenfest and Annenberg Foundations to help raise $150 million to relocate the Barnes collection from suburban Lower Merion to a spot near Philadelphia's other art museums. However, these other foundations conditioned their financial assistance on the Barnes' obtaining judicial approval to substantially change its governing rules. The trust instrument provides that the Barnes Foundation is to be governed by a board of five trustees, of whom four are to be nominated by Lincoln University, a historically black college. The petition also seeks to expand the number of board members to 15 in order to improve governance and to spread the burden of fund-raising. In September 2003, the board of Lincoln University approved a revised proposal to give it the authority to name five of fifteen board members. The attorney general supports the Foundation's petition. The matter is before Judge Ott of the Orphan's Court. While not granting them standing, the court granted three current foundation students the right to address the effect the proposal "may have upon the educational process and curriculum of the foundation's art department." *See* Patricia Horn, *Students Given Role in Barnes Case*, PHILA. INQUIRER, Oct. 30, 2003. On January 29, 2004, Judge Ott issued an interlocutory order directing directed the Barnes to first explore other fund-raising avenues – including the sale of artwork not displayed in its galleries and a separate, 137-acre estate, Ker-Feal – although Judge Ott did not rule out the possibility of approving a relocation to Philadelphia. The court did approve increasing the board to 15.

It appears that the parties in both the 2002 Hershey Trust case and the Barnes Foundation case assumed that a cy pres (rather than merely deviation) showing would be required. Note that the doctrine of deviation was applied by the Court of Common Pleas of Philadelphia to approve modifications to the famous Will of Stephen Girard. See Girard Estate, 27 Fiduc. 545 (1977); see also Girard Will Case, 386 Pa. 548, 127 A.2d 287 (1956), *reversed* Pennsylvania v. Board of Trusts, 353 U.S. 230, 1 L. Ed. 2d 792, 77 S. Ct. 806 (1957); Girard College Trusteeship, 391 Pa. 434, 138 A.2d 844 (1958); Girard Clarification Petition, 423 Pa. 297, 224 A.2d 761 (1966).

governed by the law where the trust is administered (where the trust has the most contacts). Matters appear more complex for nonprofit corporations.

As a threshold matter, for example, New York practitioners, seeking to avoid the delays and involvement of the attorney general and the courts, routinely incorporate their nonprofit clients in Delaware (which does not have a separate nonprofit corporation statute). Those starting a charity in California might be reluctant to submit to California's requirement that "not more than 49 percent of the persons serving on the board of any [nonprofit public benefit] corporation may be interested persons."[85] As a separate matter, a charity might want to employ the limited liability form to operate in a state that does not allow a single-member LLC or that requires an LLC to have a business purpose.[86] Finally, some states limit the monetary damages recoverable from directors of nonprofit corporations who breach their duty of care.[87]

At the federal level, in 2002 Congress enacted the Sarbanes-Oxley legislation, generally affecting only publicly traded companies, in response to the corporate governance scandals of Enron, WorldCom, and others. Proposals have followed for similar reform at the state level.[88] Similar changes are contemplated by self-regulating bodies.[89] The desirability of extending some of these reforms to the nonprofit sector is a subject of much debate, and could influence the choice of form (as trust or corporation), as well as the choice of state of organization.[90] However,

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[85] Cal. Corp. Code § 5227(a). Subsection (b) defines "interested person" as either "[a]ny person currently being compensated by the corporation for services rendered to it within the previous 12 months . . . excluding any reasonable compensation paid to a director as director," or any specified family member of such a compensated person. See also 13-B Maine R.S.A.. § 713A(2) (enacted March 2002).

[86] Forming a charity as a limited liability company ("LLC") is relatively new. For ease of administration and more-desirable governance structure, a charity might prefer to create a single-member LLC ("SMLLC") to a separate charity of which it is the sole member. A joint venture or partnership between charities might be better formed as an LLC. See also IRS Ann. 99-102, 1999-43 I.R.B. 545; Richard A. McCray & Ward L. Thomas, *Limited Liability Companies as Exempt Organizations – Update*, IRS Exempt Organizations Continuing Professional Education Text for FY 2001, *available at* <www.irs.gov/ >.

[87] *See Introduction*, REV. MODEL NONPROFIT CORP. ACT xxxv-xxxvi (1987).

[88] See, e.g., Cal. SB 523, SB 777, and AB 1031 (signed by the governor in September 2003).

[89] See, e.g., the rules proposed in 2002 by the New York Stock Exchange and by NASDAQ for listed companies.

[90] For example, the New York legislature is considering a proposal to apply certain of the provisions of Sarbanes-Oxley to nonprofit organizations receiving over $1 million in annual revenues or having over $3 million in assets. (See Press Release, "Spitzer Proposes Reforms of State Corporate Accountability Laws: Cites Need to Protect Public Against Abuses by For-Profit and Non-Profit Corporations," available at <http://www.oag.state.ny.us/press/2003/jan/jan23a_03.html>; Nonprofit Coordinating Committee of New York, "Sarbanes-Oxley for Nonprofits," *New York Nonprofits* (Aug. 2003), *available at* <http://www.npccny.org/newslet.htm#sarbanes>.) Note that Drexel University made headlines by voluntarily adopting many of the requirements of Sarbanes-Oxley. (See the March 10, 2003 memo from its general counsel to

the broadly-applicable standards adopted by the BBB Wise Giving Alliance recommend that no more than one person who directly or indirectly receives compensation from the charity should serve as a voting member of the board – and should not serve as chairman or treasurer.[91]

Typically, a foreign charity must register to obtain a certificate of authority in states where it operates. It is not always clear, however, what requirements a state may impose on a charity formed elsewhere, and the degree of state oversight over foreign charities remains largely untested in the courts. The state of operations should not be able to impose requirements on foreign charities *more* onerous than those imposed on its domestic charities. The issue remains about which requirements imposed on domestic charities can also be imposed on a foreign charity formed in a state with less strict requirements, such as the number of directors or their independence.

A charity operating across state lines becomes subject to the jurisdiction of the state in which it maintains assets or solicits contributions. If a charity formed in one state operates exclusively in another, ordinarily the attorney general of the state of organization does not oversee operations, and the attorney general in the state of operations does not oversee internal affairs. But the boundaries of jurisdiction can be indistinct, particularly regarding decisions by the board to make organic changes in purpose and governance. Problems can be acute for an affiliated group of separately incorporated charities formed in more than one state – notably multi-state health care systems.[92] The decision to sell assets or move operations can be a matter for both the state of incorporation and the state of operation, and answers might differ over (1) the decision to sell the assets; (2) the decision to move the resulting funds to another state; and (3) the decision to devote those funds to a new use.

Under long-standing (although sometimes criticized) conflict-of-laws principles, the "internal affairs doctrine" holds that the law of the state of incorporation applies to regulate the intra-corporate matters of a foreign corporation authorized to transact business in the state of operation.[93] Enshrined in the *Restatement (Second) of Conflict of Laws*, the doctrine has been

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the National Association of College and University Attorneys, with links to board documents, at <http://www.nacua.org/documents/Drexel_Sarbanes-Oxley_Memo.doc>.)

[91] See "BBB Wise Giving Alliance Standards for Charity Accountability" (effective March 3, 2003) and "Implementation Guide to the BBB Wise Giving Alliance Standards for Charity Accountability," *available at* <www.give.org/standards/>.

[92] See the discussion of Health Midwest, above.

[93] Section 302 of the *Restatement (Second) of Conflict of Laws* (1969), subsection 2, looks to the "local law of the state of incorporation . . ., except in the unusual case where . . . some other state has a more significant relationship to the occurrence and the parties. . . ." *See generally* Note, *The Internal Affairs Doctrine: Theoretical Justifications and Tentative Explanations for Its Continued Primacy*, 115 HARV. L. REV. 1480 (2002).

adopted in the corporations codes of over half the states.[94] However, a few states are particularly concerned about the "pseudo-foreign corporation" – the entity whose only tie to the state of incorporation is incorporation itself. California and New York, in particular, have adopted statutes applying much of their domestic corporate law to foreign corporations operating in-state that meet a threshold test. But the *Restatement* and these statutes explicitly do not apply to nonprofit corporations.

Only a few reported cases have dealt with the level of authority that a state attorney general and courts wield over foreign nonprofit corporations and trusts.[95] A California appeals court ruled: "The election and removal of officers are matters involving the internal affairs of a corporation, and California courts generally apply the laws of the place of incorporation in such instances."[96] (If the charity takes the trust form, the court continued, it would be governed by the laws of the state in which the trust is administered: "Factors to be considered in determining the place of administration are the domiciles of the trustees, the physical location of the assets constituting the res of the trust, and the place in which the business of the trust is carried on.)[97] Nevertheless, the court went on to rule: "Where a charity has been organized by California residents, is located in this state and has all of its assets and most of its activity here, we believe that actions taken in California concerning the administration of that charity should not escape the scrutiny of California law merely because the founders chose to incorporate elsewhere. Consequently, we hold that the law of California, to the extent it exists, is controlling."[98]

The high court of Maryland declined to become involved in a membership issue involving the NAACP, a foreign corporation, invoking the internal affairs doctrine. Referring to the business corporation context, the court cited a definition by the U.S. Supreme Court: "the internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs – matters peculiar to the relationships among or between the corporation and its current officers, directors, and

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[94] *See* 4 MODEL BUS. CORP. ACT ANN. § 15.05 (3d ed. 1984 & 1997 Supp.) (identifying 26 State codes that contain an exception for the internal affairs of a foreign corporation doing business in the State).

[95] Reportedly the Bishop Estate considered moving out of Hawaii in order to escape the oversight of the Hawaii attorney general – indeed, it contemplated and reforming in the Cheyenne River Sioux Reservation in South Dakota to get out from under IRS jurisdiction as well – but, as a trust, hesitated because of the necessity of obtaining court approval. *See* Brody, *A Taxing Time for the Bishop Estate*, *supra* note 69.

[96] American Center for Education, Inc. v. Cavnar, 145 Cal. Rptr. 736, 742 (Cal. App. 1978).

[97] *Id.* 743 at (citation omitted).

[98] *Id.* at 743. The court noted: "This holding, however, is not of great consequence because the differences between California and the District of Columbia law in the relevant areas are not so significant as to dictate opposite results in this case. Moreover, because the case presents issues which have not been definitively settled by the courts of California or of the District of Columbia, we shall have to seek guidance from the decisions of other jurisdictions as well." *Id.* (footnote omitted).

shareholders – because otherwise a corporation could be faced with conflicting demands."[99]

CONCLUSION

Corporate charities, attorneys general, and the courts often consider the trust doctrines of cy pres and equitable deviation when a restriction on a gift can no longer be followed. Moreover, some courts apply these doctrines to a corporate charity that amends its charitable purpose. In the absence of a statute to the contrary, however, wholesale transportation of trust law to the corporate setting is not appropriate: By choosing to found a corporate charity or make a gift other than in trust, the donor implicitly recognizes the corporate board's flexibility in governance, subject to review of its adherence to restricted gifts for abuse of discretion. But difficult open issues remain –

* What matters of interpreting restricted gifts are left to the discretion of the board, and when is resort to court required? For a charitable trust, are distinctions made between a simple grant-making entity and an operating charity – and should the corporate standards apply to trustees of operating charitable trusts?

* How readily may a corporate charity amend its purposes, and how close must the new purpose be to the prior one? May all assets acquired prior to amendment – other than explicitly restricted gifts – be used for the new purpose?

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[99] National Association for the Advancement of Colored People v. Golding, 679 A.2d 554, 559 (Md. 1996), *quoting* Edgar v. Mite Corp., 457 U.S. 624 (1982)). The Maryland court continued:

> We further explained the rationale for the doctrine in Condon v. Mutual Reserve Ass'n, 89 Md. 99, 42 A. 944 (1899), stating that:
>
> > Our courts . . . can enforce no forfeiture of charter for violation of law, or removal of officers for misconduct; nor can they exercise authority over the corporate functions, the by-laws, nor the relations between the corporation and its members, arising out of, and depending upon, the law of its creation. These powers belong only to the State which created the corporation.
>
> *Id*. at 116-17, 42 A. at 948. *Accord* Moore v. NAACP, 425 Pa. 204, 229 A.2d 477, 478-79 (1967) (upholding trial court's decision that it did not have jurisdiction over internal affairs of the NAACP, a New York corporation, and thus could not enjoin the NAACP from establishing additional chapters in Philadelphia).

In conclusion, the court held:

> Applying these principles to the facts of the instant case, we first observe that the national NAACP is a foreign corporation. As such, applying the internal affairs doctrine, we decline to interfere with its internal management decisions. Moreover, even under Maryland corporations law, applying the business judgment rule, we would not interfere with the organization's decision because the NAACP did not engage in any fraud, arbitrariness, or bad faith.

Id. at 562-63.

* When a charity operates in more than one state, or is formed in one state and operates in another, which attorneys general and courts have jurisdiction over restricted gifts and change in purpose, and which law applies?

The inherently conservative nature of the legal framework remains controversial. Rule by the dead hand pleases those who fear the prospect of unfettered discretion by current trustees, and frustrates those who believe, like Jefferson, that "the land belongs to the living." Defenders argue that relaxing deference to restrictions would reduce the value to the donor of making a charitable gift, both absolutely and relative to the value of an alternate use. Moderates counter that donors would prefer to operate in a legal structure that takes account of changing circumstances, and so adopting a limit on dead-hand control might preserve the same level of – or even increase – resources devoted to charitable purposes while furthering other social ends, such as enlarging the role of other players entrusted to act for the public good. Indeed, trust law itself is reforming, notably with the welcome 2003 liberalization of the cy pres and deviation doctrines in the *Restatement (Third) of Trusts*, as well as the controversial provision granting donors standing to enforce restrictions in the 2000 Uniform Trust Code.

Overall, the charity law's focus on donor dictate has several disadvantages. First, the more time that passes from the date of the gift, the less it makes sense to try to determine and require what the donor intended. Second, even if the donor's intent is clear, as time passes and circumstances change, the policy issue arises as to whether donor intent should continue to govern. Third, permitting donor standing to enforce restrictions risks unending litigation. Finally, while some types of charities (notably churches and grant-making foundations) are funded predominantly by donations, contributions today make up only a small percentage of the revenue of most charities, which typically function more as operating enterprises than as donor-supported charities or endowments.[100] For many charities, if the legal structure for charity governance remains donor-focused rather than board-focused, the tail could wind up wagging the dog.

While private philanthropy has a venerable history of pluralism and idiosyncrasy, restrictions are not favored as a matter of construction. Of course, even in a legal landscape that does not enforce all of the donor's restrictions forever, charities would endeavor to adhere to donor expectations and demands to the extent possible. After all, charities have sound reasons beyond their legal obligations to honor donors' wishes.

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[100] As of 1997, private contributions accounted for just under 20 percent of the total revenue received by charities and social welfare organizations. MURRAY S. WEITZMAN, NADINE T. JALANDONI, LINDA M. LAMKIN, AND THOMAS H. POLLAK, THE NEW NONPROFIT ALMANAC AND DESK REFERENCE table 4.1 (Independent Sector 2002). The rest of the sector's revenues came from dues and fees (38 percent), government grants and contracts (31 percent), and investments and other sources (11 percent). By excluding health care – which accounts for half of the sector's revenues – private donations rise to 35 percent. *Id.* Churches depend almost exclusively (95 percent) on contributions. *Id.* at 92. Finally, grant-making funds – including community foundations, private foundations, and donor-advised funds – are supported entirely from contributions and investment income.