

ARTICLES

EUTHANIZING SMALL CHARITIES: THE THREAT OF SMALL TRUST TERMINATION STATUTES

ALYSSA A. DIRUSSO*

I. INTRODUCTION AND BACKGROUND

Perpetual charitable trusts are increasingly a luxury available only to the most affluent class. In a growing number of American states, generous people of moderate means can no longer create a charitable trust with the assurance that it will outlast them. Whereas donors of all wealth backgrounds may design their charitable trusts to be perpetual, modest trusts are at growing risk of involuntary termination.

With the widespread adoption of the Uniform Trust Code, many American states are enacting statutes that grant a trustee full discretion to terminate a trust on the sole ground that it has too little money to justify administrative expenses.¹ Section 414(a) of the Uniform Trust Code states: “After notice to the

*Whelan W. and Rosalie T. Palmer Professor of Law at Samford University’s Cumberland School of Law. J.D., University of Texas School of Law; B.S., Psychology, Carnegie Mellon University. The Author wishes to thank her excellent research assistants, Faye Doss and Bradley Foster, the professors who attended the Cumberland Faculty Colloquium, and the Institute for Third Sector Research (ISTR), at which this article was presented as a work-in-progress.

¹ See David M. English, *The Uniform Trust Code (2000): Significant Provisions and Policy Issues*, 67 MO. L. REV. 143, 173–74 (2002); Alan Newman, *The Intention of the Settlor Under the Uniform Trust Code: Whose Property is it, Anyway?* 38 AKRON L. REV. 649, 668–69 (2005); see also Alberto B. Lopez, *A Reevaluation of Cy Pres Redux*, 78 U. CIN. L. REV. 1307, 1311 (2010) (“[T]he UTC has been adopted in twenty-one jurisdictions and bills proposing its adoption are making the legislative rounds in several states.”).

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 insufficient to justify the cost of administration.”² The Uniform Trust Code also permits a court to terminate a trust, or modify its terms or trustee, if the court reaches the same conclusion on the relationship between trust value and administrative costs.³

The benefit of such a rule is clear: increased efficiency. Channeling under-funded trusts toward extinction relieves the sector of resources needed to continue their administration. The rule certainly benefits for-profit fiduciaries, like financial institutions, which have little appetite for trusts whose resources generate insignificant fees. Scholars have touted the benefits of uniformity in law to the charitable sector.⁴ But what are the costs of this rule? What does society lose by exterminating charities with scarcer resources? Is there harm in allowing only survival of the financially-fittest in the charitable sector?

Professor Robert Sitkoff has argued that agency costs often come to bear upon trust law.⁵ The organic structure of a trust causes management by the trustee to be separated from risk-bearing—in a private trust, by the beneficiary; in a charitable trust, by society or those members of society that the trust’s purpose benefits.⁶ This structure creates incentives for self-serving and often economically inefficient behavior.⁷ Issues of agency costs are relevant in the decision whether to terminate a private trust.⁸ It follows that these costs may be relevant in the charitable trust context as well.

² UNIF. TRUST CODE § 414(a) (amended 2005).

³ *Id.* § 414(b).

⁴ See, e.g., Garry W. Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1115, 1179–80 (2007).

⁵ See Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 623–24 (2004) [hereinafter Sitkoff, *Agency Costs*].

⁶ See *id.* at 640–43; see also Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565, 566 (2003) [hereinafter Sitkoff, *Trust Law*].

⁷ See generally Sitkoff, *Agency Costs*, *supra* note 5, at 636–44, 658–60 (discussing agency cost in the context of trust management); Sitkoff, *Trust Law*, *supra* note 6, at 568–82, 588 (comparing efficiency principles in corporate markets and the risk-management model found in donative trusts); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–30 (1976) (analyzing business efficiency in the context of an agency relationship).

⁸ See Sitkoff, *Agency Costs*, *supra* note 5, at 657–59.

Take the potential role of agency costs in the following example: A charitable trust for the purpose of supporting Boy Scout activities in Maine is funded with \$30,000. The donor has died, and through a series of mergers, the trustee is a national banking association. The trustee fees are 5% of the value of the trust, or \$1,500. Even if the value to the donor (now deceased) and the beneficiaries (the Boy Scouts) to have the trust continue to operate is significant—say, \$10,000—the trustee will choose to terminate the trust if the fees do not justify the effort exerted. The trust is terminated, and the assets are distributed to a community foundation. Such distributions of assets in the charitable sector do not follow donors' priorities, but instead skew towards the interests of the second-sector entity serving as fiduciary.

There are good doctrinal reasons for questioning whether a trustee deciding to terminate a charitable trust will make a decision in the best interests of charity and society.⁹ Agency costs or other factors might lead a trustee to make one of two wrong decisions: to continue a trust that ought to be terminated or to terminate a trust that ought to be continued.¹⁰ The focus of this Article is to explore the possibilities of societal and philanthropic harm in the instances that trustees wrongly choose to terminate small charities.

I argue that there are two key costs of euthanizing small charities: depleting democracy in philanthropy and shrinking diversity in charitable focus. To support these claims of harm to democracy and diversity in charity, this Article reviews empirical evidence mined from tax returns: first, on disparity between charitable goals of the well-funded trust and the less-so, and second, on diversity of focus in smaller versus larger charities.

The first cost of terminating small charities is the reduction of philanthropic democracy. Policy decisions to promote the termination of under-capitalized trusts allow wealthy individuals to dominate the creation of durable charitable trusts. To the extent that the philanthropic patronage of the rich departs from the goals of the masses (opera support versus poverty relief, for example),¹¹ supporting only lucrative trusts moves charity away

⁹ See *id.* at 664–65.

¹⁰ See generally *id.* at 658–59 (discussing the role agency costs play in modification or termination of trusts).

¹¹ See Miranda Perry Fleischer, *Charitable Giving and Utilitarianism: Problems and Priorities*, 89 *IND. L.J.* 1485, 1503 (2014) (highlighting distributive justice concerns in charitable giving).

from democracy toward aristocracy.

In a connected malady, diversity suffers: excluding moderately-funded trusts eliminates significant minority support for tailored causes. For example, a family touched by a particular disease may want to create a charitable trust to support research and treatment for that disease. Charities focused on narrow causes may need less funding—and receive less funding—than those focused on broad ones.¹² By eliminating smaller trusts, we will wipe out many targeted charities in favor of fewer, undifferentiated ones. We will close the neighborhood toy store and flower shop and support only the mega-mall. The theory of agency costs would predict that trustees who are authorized to terminate a small trust under a statute such as Section 414(a) of the Uniform Trust Code may at times terminate small trusts that ought to be continued.¹³

A. *Study Objectives*

The purpose of this study is to explore what consequences the inefficient termination of small trusts would have on the big picture of charitable trusts.

Termination of small charitable trusts may disrupt the balance of society's charitable priorities if smaller trusts tend to have substantively different primary goals than larger charities. If smaller trusts represent significantly different charitable goals or purposes than larger trusts, terminating smaller trusts will minimize the representation of these philanthropic priorities in the overall trust landscape. Because under this theory the surviving charities would not accurately represent or reflect the broad spectrum of charitable priorities across donors of all income levels, this outcome is termed the "democracy question."

Termination of small trusts might also adversely impact the charitable sector if smaller charities demonstrate more variety in focus than larger charities. Assuming for the time being that diversity and variety are positive goals for the third sector, to the extent that the diversity of the charitable sector is enhanced by contributions from smaller charities, eliminating them would result in less variety in charitable aims. This risk that charitable

¹² Cf. Leslie G. Espinoza, *Straining the Quality of Mercy: Abandoning the Quest for Informed Charitable Giving*, 64 S. CAL. L. REV. 605, 606–07 (1991) (exploring what drives higher fund-raising costs for charities supporting "unpopular and fringe causes").

¹³ See Sitkoff, *Agency Costs*, *supra* note 5, at 636–44, 657–59 (discussing agency costs in trust management and exploring tensions related to those costs).

trusts would become less diverse if smaller trusts were terminated is termed the “diversity question.”

There are therefore three primary objectives of this study: (1) to determine whether smaller charities tend to have substantively different primary goals than larger charities (the democracy question); (2) to determine whether smaller charities demonstrate more variety in focus than larger charities (the diversity question); and (3) to conclude whether differences in types of substantive goals and differences in variety of goals justify reluctance to terminate small charitable trusts.

II. METHODOLOGY

All data comes from federal tax returns filed by individual charities with the United States Internal Revenue Service in 2007. The data from the tax forms was compiled by GuideStar USA, Inc. and sorted and analyzed using GuideStar Premium, a web-based data service.¹⁴

For the analyses described in this Article, GuideStar Premium was used to sort the tax data to select charities that included the keyword “trust” and were categorized as organizations described under Section 501(c)(3) of the Internal Revenue Code.¹⁵ From these charities, the data were sorted to extract two groups: (1) only those charities that reported annual income under \$100,000 (the “Smaller Charities Group”) and (2) only those charities that reported annual income over \$10,000,000 (the “Larger Charities Group”).¹⁶ Land trusts were then eliminated from both groups because land trusts that hold real estate tend to have large asset values despite low income.¹⁷ At this point in the analysis, there were 23,311 organizations represented in the Smaller Charities Group and 1,659 organizations represented in the Larger Charities Group.¹⁸

Next, the National Taxonomy of Tax-Exempt Entities Core Codes (“NTEE codes”) of the Smaller Charities Group were

¹⁴ GUIDESTAR, <http://www.guidestar.org> (last visited Sept. 2, 2014).

¹⁵ Section 501(c)(3) exempts certain corporations and trusts, including charitable trusts, from taxation. I.R.C. § 501(c)(3) (2012).

¹⁶ See *infra* Tables 1 to 4, Figures 2 & 3.

¹⁷ See generally J. Breting Engel, *The Development, Status, and Viability of the Conservation Easement as a Private Land Conservation Tool in the Western United States*, 39 URB. LAW. 19, 32–36 (2007) (discussing the origins of land trusts and use of land trusts today).

¹⁸ This information is located in a comprehensive data report generated through GuideStar. The report is on file with the author.

compared to the Larger Charities Group.¹⁹ NTEE codes are the industry standard for classifying nonprofit organizations, created by the National Center for Charitable Statistics and used by the Internal Revenue Service.²⁰ NTEE codes are based on categories (e.g., Arts, Culture, and Humanities or Educational Institutions) and subcategories (e.g., Performing Arts and Museums & Museum Activities as subcategories of Arts, Culture and Humanities).²¹ There are 26 categories (A-Z) and multiple sub-categories within most levels.²²

To assess diversity between the two groups of charities, the numbers of different categories of NTEE codes that appeared among the most common top fifteen subcategories of charities within each group were compared.²³ To determine whether there is a substantive difference in focus between the Smaller Charities Group and the Larger Charities Group, the NTEE codes of the top five charitable subcategories for the two groups were compared.²⁴ A discussion of the results follows.

III. RESULTS

The analysis revealed that there is a significantly wider range of category types in the Smaller Charities Group than in the Larger Charities Group, and therefore a risk to charitable diversity exists.²⁵ The analysis also revealed that there is a distinction between the main areas of focus between the two groups, and therefore a risk to charitable democracy exists.²⁶

A. Charitable Diversity

Smaller charities (those with annual income under \$100,000) have greater variety in focus than larger charities (those with annual income over \$10,000,000).²⁷ The fifteen most common NTEE codes for large charities included representation only from categories Y (Mutual/Membership Benefit

¹⁹ See *infra* Tables 1 to 4, Figures 1 & 2.

²⁰ See *NTEE Core Codes (NTEE-CC) Overview*, NAT'L CTR. FOR CHARITABLE STATISTICS, <http://nccs.urban.org/classification/NTEE.cfm> (last visited Mar. 13, 2015).

²¹ *Id.*

²² *Id.*

²³ See *infra* Table 1.

²⁴ See *infra* Table 4, Figures 1 & 2.

²⁵ See *infra* Tables 1.

²⁶ Compare *infra* Table 2, with Table 3.

²⁷ Compare *infra* Table 2, with Table 3.

Organizations), T (Philanthropy, Voluntarism, and Grantmaking), E (Health—General & Rehabilitative), S (Community Improvement, Capacity Building), and B (Educational Institutions).²⁸ The NTEE codes for small charities showed greater diversity, including representation from nine categories: T (Philanthropy, Voluntarism, and Grantmaking), B (Educational Institutions), O (Youth Development), C (Environmental Quality Protection, Beautification), I (Crime, Legal Related), Y (Mutual/Membership Benefit Organizations), Z (Unknown) X (Religion, Spiritual Development), and A (Arts, Culture, and Humanities).²⁹ Therefore, whereas the category of focus of the top fifteen subcategories of charities could be collapsed into only five groups for the wealthiest charities, it spanned nine groups for the poorest.³⁰

The following chart (Table 1) shows the greater variety of NTEE categories in small charitable trusts as opposed to large charitable trusts. The number in parentheses reflects how many charitable entities in the sample were included in this code.

²⁸ See *infra* Table 1.

²⁹ See *infra* Table 1.

³⁰ See *infra* Tables 2 & 3.

TABLE 1

Small Charitable Trusts	Large Charitable Trusts
T90: <i>Named Trusts/Foundations N.E.C.</i> (1,720)	Y43: <i>Voluntary Employees Beneficiary Associations (Non-Government)</i> (132)
B82: <i>Scholarships, Student Financial Aid, Awards</i> (773)	T90: <i>Named Trusts/Foundations N.E.C.</i> (36)
T99: <i>Other Philanthropy, Voluntarism, and Grantmaking Foundations N.E.C.</i> (685)	T99: <i>Other Philanthropy, Voluntarism, and Grantmaking Foundations N.E.C.</i> (29)
O41: <i>Boy Scouts</i> (288)	Y20: <i>Insurance Providers/Services (other than Health)</i> (28)
T20: <i>Private Grantmaking Foundations</i> (275)	T20: <i>Private Grantmaking Foundations</i> (25)
C34: <i>Land Resources Conservation</i> (264)	T31: <i>Community Foundations</i> (21)
T22: <i>Private Independent Foundations</i> (264)	T22: <i>Private Independent Foundations</i> (14)
B99: <i>Education N.E.C.</i> (199)	T12: <i>Fund Raising and/or Fund Distribution</i> (9)
I72: <i>Child Abuse, Prevention of</i> (164)	S47: <i>Real Estate Organizations</i> (9)
Y43: <i>Voluntary Employees Beneficiary Associations (Non-Government)</i> (162)	Y44: <i>Voluntary Employees Beneficiary Associations (Government)</i> (9)
T12: <i>Fund Raising or Fund Distribution</i> (158)	E11: <i>Single Organization Support</i> (8)
Z99: <i>Unknown</i> (148)	E21: <i>Community Health Systems</i> (8)
X11: <i>Single Organization Support</i> (140)	E22: <i>Hospital (General)</i> (8)
A80: <i>Historical Societies and Related Activities</i> (126)	B20: <i>Elementary, Secondary Ed</i> (7)

Compare the focus of the top fifteen most common NTEE subcategories for large charitable trusts (five categories, as shown in Table 2) with those for small charitable trusts (nine categories, as shown in Table 3):

TABLE 2

Type of Organization: Large Charities	Number of Organizations	Percentage of Top 15
<i>Y: Mutual/Membership Benefit Organizations, Other</i>	169	47.34%
<i>T: Philanthropy, Voluntarism, and Grantmaking</i>	134	37.54%
<i>E: Health—General & Rehabilitative</i>	38	10.64%
<i>S: Community Improvement, Capacity Building</i>	9	2.52%
<i>B: Educational Institutions</i>	7	1.96%

TABLE 3

Type of Organization: Small Charities	Number of Organizations	Percentage of Top 15
<i>T: Philanthropy, Voluntarism, and Grantmaking</i>	3,102	55.38%
<i>B: Educational Institutions</i>	1207	21.55%
<i>O: Youth Development</i>	288	5.14%
<i>C: Environmental Quality Protection, Beautification</i>	264	4.71%
<i>I: Crime, Legal Related</i>	164	2.93%
<i>Y: Mutual/Membership Benefit Organizations, Other</i>	162	2.89%
<i>Z: Unknown</i>	148	2.64%
<i>X: Religion, Spiritual Development</i>	140	2.50%
<i>A: Arts, Culture, and Humanities</i>	126	2.25%

B. Charitable Democracy

Smaller charities (those with annual income under \$100,000) have a substantively distinguishable difference in focus than larger charities (those with annual income over \$10,000,000). Charities devoted to scholarships and scouting appear only in the top five subcategories for smaller charities, whereas charities devoted to volunteer employee benefit associations and insurance providers and services appear only in the top five subcategories for larger charities.³¹ Compare the focus of the top five most common NTEE codes:

TABLE 4

Most Common NTEE Codes: Large Charities	Most Common NTEE Codes: Small Charities
1. Voluntary Employees Beneficiary Associations (Non-Government)	1. Named Trusts/Foundations
2. Named Trusts/Foundations	2. Scholarships, Student Financial Aid, Awards
3. Other Philanthropy, Voluntarism, and Grantmaking Foundations	3. Other Philanthropy, Volantarism, and Grantmaking Foundations
4. Insurance Providers/Services (other than Health)	4. Boy Scouts
5. Private Grantmaking Foundations	5. Private Grantmaking Foundations

As the figures below show, the priority order and proportion of these types of charitable focus varies dramatically between small charitable trusts and large charitable trusts.

³¹ See *infra* Table 4.

FIGURE 1:

**Top Five Types of Large Charitable Trusts
(Annual Income Over \$10,000,000)**

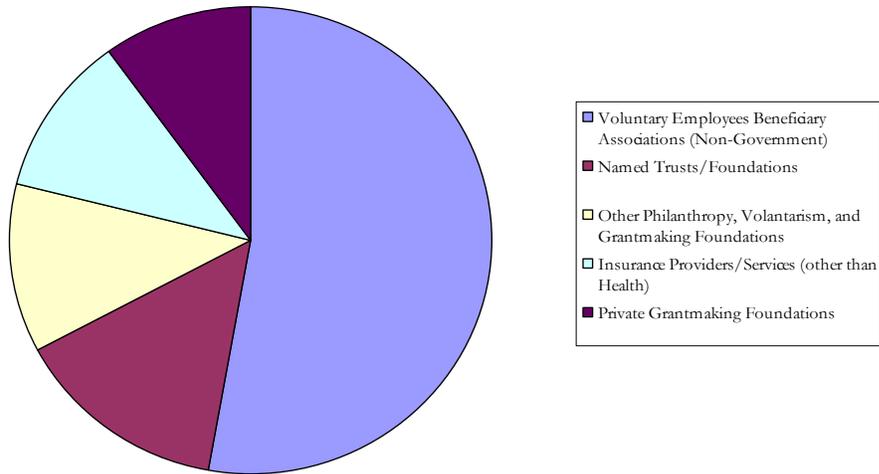
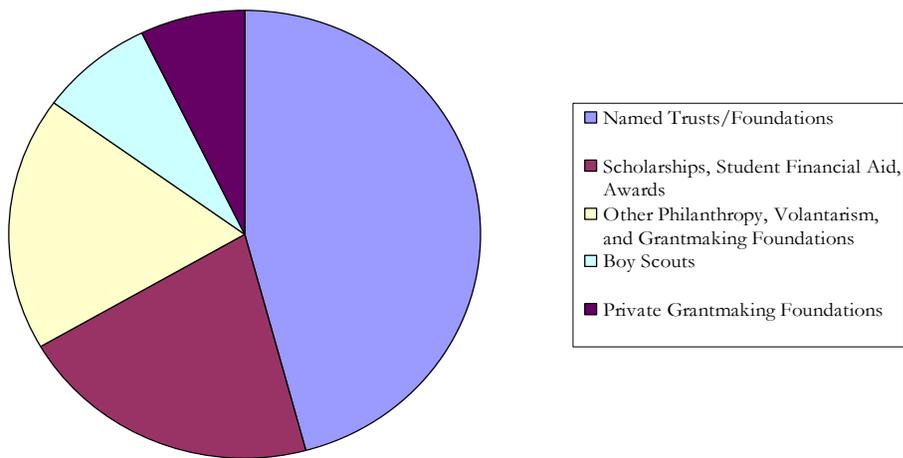


FIGURE 2:

**Top Five Types of Small Charitable Trusts
(Annual Income Under \$100,000)**



The data analysis therefore supports the hypotheses that smaller charities do tend to demonstrate greater diversity in focus than larger charities, and that smaller charities do tend to have a substantive difference in focus than larger charities. Future studies could provide more refined analysis, including whether the categorical exclusion of land trusts is appropriate, whether income is an appropriate proxy for assets, and whether using the keyword “trust” is sufficient to insure that charities used in the analysis have a trust and not a corporate form.

VI. CONCLUSION AND SUMMARY OF KEY FINDINGS

Smaller charities do tend to have different substantive primary goals than larger charities (the democracy question).³² Charities devoted to scholarships and scouting appear only in the top five subcategory types for smaller charities, whereas charities devoted to volunteer employee benefit associations and insurance providers and services appear only in the top five subcategory types for larger charities.³³

Smaller charities do demonstrate more variety in focus than larger charities (the diversity question).³⁴ There are only five categories represented among the top fifteen subcategories of organizational focus of larger charities but nine categories represented among the top fifteen subcategories of organizational focus of smaller charities.³⁵ Preliminary data analysis also suggests that certain subcategories of charities (“Environmental Education and Outdoor Survival Programs” and organizations that focus on specific religions, for example) do not exist as very well-funded charities and may only exist as smaller charities.³⁶ Therefore, certain types of charities could become extinct if smaller charities were terminated.

These findings support the conclusion that differences in types of substantive goals and in variety of goals justify reluctance to terminate small charitable trusts. Terminating smaller charitable trusts would result in a different allocation of charitable resources (harming charitable democracy) and hamper the variety of charitable focus (harming charitable

³² See *supra* Part III(B).

³³ See *supra* Table 4.

³⁴ See *supra* Part III(A).

³⁵ See *supra* Tables 2 & 3.

³⁶ See *supra* Part III(A).

diversity). Lawmakers should pay greater attention to this potential cost when enacting statutes that authorize trustees to extinguish small charities.

In adopting the small trust termination statute of the Uniform Trust Code, or similar statutes in other states or nations, we must be cognizant of the trade-off. Is administrative efficiency a priority over democratic and diverse charity? If not, we should be reluctant to put our smaller charities to sleep.