

Alyssa A. DiRusso  
 Associate Professor of Law  
 Birmingham, Alabama, USA

## Euthanizing Small Charities (Work in Progress)

### Rationale 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 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.

Section 414(a) of the Uniform Trust Code states that, "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 insufficient to justify the cost of administration." 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.

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, who have little appetite for trusts whose resources generate insignificant fees. Scholars have touted the benefits of uniformity in law to the charitable sector. 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. See Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 Cornell L. Rev. 621 (2004). For further background on agency costs in general, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976). 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 it that the trust's purpose benefits). This structure creates incentives for self-serving – and often economically inefficient – behavior. See Robert H. Sitkoff at 624. Issues of agency costs are relevant in the decision whether to terminate a private trust. See *id.* at 658-659. It follows that these costs may be relevant in the charitable trust context as well.

We have 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. Agency costs or other factors might lead a trustee to one of two wrong decisions: to continue a trust that ought to be terminated, or to terminate a trust that ought to be continued. The focus of this article is to explore the possibilities of societal and philanthropic harm in the instances trustees wrongly choose to terminate small charities.

### 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 Philanthropic Research, Inc. (a nonprofit organization operating under the name "Guidestar" – see www.guidestar.org), and sorted and analyzed using Guidestar Premium, a web-based data service offered by Philanthropic Research, Inc.

For the analyses described on this poster, I used Guidestar Premium 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. From these charities, I sorted the data to extract two groups: (1) only those charities who reported annual income under \$100,000 (the "Smaller Charities Group") and (2) only those charities who reported annual income over \$10,000,000 (the "Larger Charities Group"). Land trusts were then eliminated from both groups, because land trusts tend to have large asset values despite low income, because of the real estate held in trust. 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.

Next, I compared the National Taxonomy of Tax-Exempt Entities Core Codes ("NTEE codes") of the Smaller Charities Group to the Larger Charities Group. 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. 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).

To assess diversity between the two groups of charities, I compared the number of different categories of NTEE codes that appeared among the most common top fifteen subcategories of charities within each group. The analysis revealed that there is a significantly wider range of category types in the Smaller Charities Group than in the Larger Charities Group (see charts below).

To determine whether there is a substantive difference in focus between the Smaller Charities Group and the Larger Charities Group, I compared NTEE codes of the top five charitable subcategories for the two groups. There is a distinction between the main areas of focus between the two groups (see charts below).

The preliminary 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.

It must be noted that these results are based on preliminary data only, and that this is a working paper not yet ready for citation. Before publication, several questions must be addressed, 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.

### Aims and Objectives

- To determine whether smaller charities tend to have different substantive primary goals than larger charities (the democracy question).
- To determine whether smaller charities demonstrate more variety in focus than larger charities (the diversity question).
- To conclude whether differences in types of substantive goals and differences in variety of goals justify reluctance to terminate small charitable trusts.

### Findings

- **Smaller charities do tend to have different substantive primary goals than larger charities** (the democracy question). 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.
- **Smaller charities do demonstrate more variety in focus than larger charities** (the diversity question). 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. 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. Certain types of charities, therefore, could become extinct if smaller charities were terminated.
- **These findings support the conclusion that differences in types of substantive goals and differences 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 diversity). Lawmakers should pay greater attention to this potential cost when enacting statutes that authorize trustees to extinguish small charities.

### 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). 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. Compare the focus of the top fifteen most common NTEE categories:

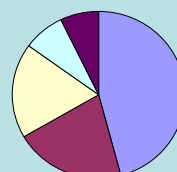
Type of Organization: Large Charities	Number of Organizations	Percentage of Top 15
Y: Mutual/Membership Benefit Organizations, Other	194	51.73%
T: Philanthropy, Voluntarism, and Grantmaking	109	29.07%
E: Health—General & Rehabilitative	38	10.13%
S: Community Improvement, Capacity Building	9	2.40%
R: Educational Institutions	7	1.87%

Type of Organization: Small Charities	Number of Organizations	Percentage of Top 15
T: Philanthropy, Voluntarism, and Grantmaking	3102	55.38%
B: Educational Institutions	1207	21.55%
O: Youth Development	288	5.14%
C: Environmental Quality Protection, Beautification	264	4.71%
E: Crime, Legal Related	164	2.93%
Y: Mutual/Membership Benefit Organizations, Other	162	2.89%
Z: Unknown	148	2.64%
X: Religion, Spiritual Development	140	2.50%
A: Arts, Culture, and Humanities	126	2.25%

### Charitable Democracy

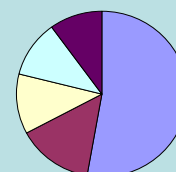
Smaller charities (those with annual income under \$100,000) have a substantively distinguishable difference in focus than larger charities (those with annual income over \$10,000,000). Charities devoted to scholarships and scouting appear only in the top five subcategories for smaller charities, whereas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

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



- Named Trusts/Foundation Awards
- Scholarships, Student Financial Aid, Awards
- Other Philanthropy, Voluntarism, and Grantmaking Foundations
- Private Secular
- Private Grantmaking Foundations

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



- Volunteer Employee Benefit Associations (Other Government)
- Named Trusts/Foundation Awards
- Other Philanthropy, Voluntarism, and Grantmaking Foundations
- Insurance Provider/Service (Other than Health)
- Private Grantmaking Foundations