

Help! Someone Hijacked My Foundation!

By Douglas W. Stein

Imagine creating a private foundation (i.e., a type 3 supporting organization) to benefit the poverty-stricken region of a foreign country in which your client was born. You, the attorney, your client, his trusted financial advisor, and a member of a national charity sit on the board of directors. The members of the board work well together until your client dies. After your client dies, the board appoints another member of the national charity to the board. In a short time you find yourself and your client's former financial advisor off of the board.

The new board members change the state of incorporation to a state with a less aggressive attorney general, change the corporate charter of the foundation so the country in which your client was born no longer receives any funds from the charity, and hire the new president's son as the financial advisor. In addition, the new board terminates any outstanding grants made by the prior board which benefited the foreign country in which your client was born.

The board members now incur travel expenses of over \$25,000 per year, increase their compensation, and make grants to charities to which they are related to or are also members of the board. You contact the office of your state's attorney general but no one is interested because there has been no breach of fiduciary duty. You contact the IRS advising that the corporate charter has been changed, but to no avail. Slowly, you come to realize that your client's foundation has been hijacked and you are powerless to stop it.

Clearly, this was a tragic turn of events. Unfortunately, such cases are not rare. For example, the recent Carl B. & Florence E. King Foundation case, in which the Texas attorney general obtained a judgment exceeding \$21 million from the officers, directors, and former officers and directors, is an example of a type of hijacking of a charitable organization.

And, there is a similar problem with "mis-
See HIJACKED, next page

sion drift," in which a foundation's purposes and activities change over time. Many observers consider the Ford Foundation to be the classic case in this category. After the death of its founder, it undertook a number of projects that would have been antithetical to his conservative social and political views. If such changes are dramatic or extreme, they can likewise amount to a hijacking.

While the hijacking of the foundations just described may be particularly extreme, hijackings are probably more common than one would expect.¹ After experiencing a hostile takeover of my client's charitable foundation firsthand, I resolved to prevent a future hijacking.

Choice of Entity

For tax purposes, charities can be created as either corporations or trusts.² Although a number of factors must be considered in choosing the correct entity, the key criteria for preventing a hijacking is the ease of changing the entity's formation documents and charitable charter. Of course, tax issues such as differences in tax rates if the charity recognizes unrelated taxable income³ or has an unrelated debt financed income⁴ are important as well.

Accordingly, a critical factor, and

arguably one of the most important in preventing a hijacking, is the choice of entity. For these purposes, the ease of changing the charitable charter and composition of the board is the cornerstone of planning. As a general rule, corporate charters are easier to amend than the terms of a trust. Usually, to change a corporate charter such change must be approved by the attorney general. Often, changes to a corporate charter will include changing the situs of the organization to a state which has a lax or inactive attorney general. Once the corporation has its situs in a state in which the attorney general plays a minimal role in oversight, the charitable purpose of the corporation can be easily changed to accommodate the board's desires and solidify the hijacker's control over the entity.

Unlike a corporation, a trust is usually significantly more difficult to change. Not only will the attorney general be involved because the trust is a charitable trust, but a court proceeding is also necessary to amend or modify the terms of the trust. The doctrine of cy pres allows courts to change the purposes of a charity upon showing that the charitable purposes is impossible to achieve or unlawful which requires that a high burden be met. In addition, even if the doctrine of cy pres is applicable, the trustees named in the instrument are usually significantly more difficult to change,

thus making it very important that the settler trust the trustees.

Because irrevocable trusts are generally difficult to change, a charity formed as a trust has the distinct advantage of being difficult to hijack, unless the trustee is hijacking the charity and the charitable purpose becomes impossible to discharge. However, the risk of a trustee hijacking a trust can be minimized by carefully choosing the trustee and ensuring that sufficient safeguards are built into the trust. The remainder of this article is dedicated to discussing some of the safeguards that can and should be built into a charitable trust to minimize the trustee from hijacking the trust.

Mandatory Distributions

When drafting a charitable trust, the trust instrument can require mandatory distributions to a specific charity or for a very narrow charitable purpose. This charitable purpose can be very detailed and should be carefully crafted. In fact, more attention should be given to describing the charitable charter and the donor's goals than to almost any other issue. For example, a trust could require that 5% of the trust property be distributed to XYZ school and that no other distributions be made. In the alternative, the trust could set forth a range for the amount to be distributed.⁵

See HIJACKED, page 11

Poison Pill

Another option is to include a poison pill. A poison pill could be structured such that if the 5% distribution to the XYZ school is not made for a period of time, the trust will terminate or a new trustee is automatically appointed. In the alternative, the charity could be given the ability to remove the trustee and appoint a new successor trustee.⁶ While great care must be taken when drafting these types of provisions to ensure the trust qualifies for a charitable deduction, a poison pill should chill any change effecting the distributions to the named charitable beneficiary.

Trust Protector

Similar to an irrevocable trust, a charitable trust could name a trust protector. A trust protector is becoming much more common in dynastic or long-term trusts, due to the length of time the trust is expected to last and a donor's desire that the trust goals be properly implemented. The same can be accomplished with a charitable trust. For example, the trust protector could be given the power to veto any change of the charitable beneficiary. The trust should also require that the trust protector be given notice of any proposed modification to the trust, including changes of situs, significant changes in distributions, and approval of any membership dues and other significant expenses.

To minimize the trustee's ability to amend the trust, the trust protector could be given the power to alter or amend the administrative provisions of the trust, as the trustee deems appropriate. It is vitally important that the trust protector not be given the power to change the charitable purpose or the charitable beneficiaries, unless such change meets some objective criteria.

Consideration should be given to when or if the trust should terminate, liquidate, or merge. It may be best to permit such changes only when it is extremely difficult or impossible to discharge the trust's charitable purpose. It is important to be mindful that the trust must also be protected from the whims and vicissitudes of the trust protector as well as the trustee. Furthermore, if a trust protector is named, it is wise to also name a successor trust

protector or a method by which the trust protector can be named.

Change of Trustee

Consider requiring that the appointment of new trustees must be by unanimous consent of all the trustees and the trust protector, if there is one, as well as the consent of the primary charitable beneficiary, if any. Although these provisions increase the complexity of trust administration, they also reduce the risk that a successor trustee will have ulterior motives. Of course, there are real risks to this particular power. First, a charitable beneficiary, if a trustee, is unlikely to ever consent to his or her removal even if such a change is in the trust's best interest. Second, it may be very difficult to obtain unanimous consent, so some form of tie breaker needs to be devised. Finally, care needs to be taken to make certain that the successor trustees can work together productively.

Where Only a Corporation Will Work

There are times at which only a corporation will do (e.g., example, if a charity will be holding S corporation stock or is expected to have significant amounts of unrelated business income). Because a corporation will usually result in a lower tax, due to the compressed tax rates of trust, consideration should be given to a Michigan trustee corporation.⁷ A Michigan trustee corporation is a corporation created by the trustees of a charitable trust for the express purpose of carrying out the provisions of such trust.⁸ The trustee corporation has all the powers of a corporation but is charged solely with carrying out the terms of the trust. The trust instrument is attached to the certificate of corporation and in effect becomes a part of it. Unlike a standard corporation, the officers and directors of the corporation have the same degree of responsibility with respect to the trustee corporation's assets as a trustee of the trust creating such corporation, except where a less degree or a particular degree of responsibility is prescribed in the trust instrument.⁹ In addition, if the grantor of the trust alters, amends, enlarges, or restricts any of the terms of the trust, such change must be filed as if it were an amendment to the articles of incorporation. Importantly, no amendment to the articles is valid if it

entirely changes the original purpose of the corporation.

In sum, a Michigan trustee corporation is a hybrid entity. It can have the flexibility and taxation of a corporation but with the limited scope that can only be provided by a trust.

Conclusion

If great care is taken in the early stages of creating a charitable organization, both the effectiveness of the organization and an increased likelihood that the organization will accomplish the donor's objectives can be achieved. To minimize the likelihood that a charitable organization will be hijacked, the choice of entity should be a trust. Safeguards, like the appointment of a trust protector, need to be included in the trust instrument to protect the trust from the trustee. The provisions which can be included in a trust to reduce the risk of a hijacking are limited by the diligence and imagination of the attorney.

Endnotes

1. For a great article discussing charitable scandals, but not true hijackings, see Michelle D. Monse, "Scandal Is a Good Teacher," *Trusts & Estates* (February 2006), at p. 56.
2. For purposes of this article, we will that assume most charitable organizations are corporations.
3. IRC §512.
4. IRC §514.
5. If a range is used great care must be taken to ensure that the minimum distribution requirements of IRC §4942, if applicable, are satisfied.
6. Great care should be taken when drafting this provision to ensure that the charity will not hijack the client's foundation.
7. Mich. Comp. Laws §§450.148 et seq.
8. Mich. Comp. Laws §450.148
9. Mich. Comp. Laws §450.153.

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