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# Foundations: Organization and Operation

Alexander Brodsky\* and Harry E. Brodsky\*

## I. Some Formal Definitions and Considerations.

- A. The foundation is not, as such, a form of legal entity. It has been adequately described as a “non-governmental, non-profit organization having a principal fund of its own, managed by its own trustees or directors, and established to maintain or aid social, educational, charitable, religious, or other activities serving the common welfare.” (F. Emerson Andrews, *Philanthropic Foundations*, p. 11—Russell Sage Foundation, N.Y. 1956.)
- B. State law recognizes that the foundation may be organized as a corporation (usually under a non-profit membership corporation law) or as a trust, testamentary or inter vivos; or as an unincorporated association.
- C. The federal Internal Revenue Code recognizes these forms in different sections:
- 1.—Section 501 (c)(3)—“Corporations and any community chest, fund or foundation . . .”
  - 2.—Section 170 (c)(2)—“A corporation, trust, or community chest, fund or foundation . . .”
  - 3.—See also Sections 2055 (a)(2) and (3) (estate tax) and 2522 (a)(2) (gift tax).
  - 4.—The federal tax law recognizes the purpose of philanthropy in Sections 501 (c)(3) and 170 (c)(2) in terms verbally different from the above description but not significantly different in substance.

## II. The Role of Philanthropy and of Foundations in our Society: The Substance Underlying the Definitions.

- A. A foundation is simply one kind of philanthropic institution. Typically, it functions by disbursing its funds in the form of grants to operating philanthropic bodies, such as schools, hospitals, and social service agencies.
- B. The philanthropic body is a hybrid plant. Whereas the ordinary business organization uses private resources and means to

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pursue private ends and government uses public resources to pursue public ends, the philanthropic foundation uses private resources of men and money to pursue essentially public ends.

- C. This special role of philanthropy helps us to understand:
1. why the law (including tax law) confers special benefits upon it, and
  2. the nature of the special problems it creates, with which the law should try to deal.
- D. What are the special benefits conferred by law? In earlier times, the significant exceptions made for philanthropy related to the Rule against Perpetuities, rules against accumulation, and the like. But today, the critical issues relate to the tax laws, particularly federal.
- E. Not only have the tax laws exempted foundations from income tax (this is not very special, because many non-profit organizations are exempt from tax) but they have provided that contributions to foundations by individuals and corporations shall, within limits, be deductions from income. This is in the nature of a tax subsidy.
- F. The reason for the benefit must be in the notion that philanthropic institutions, including foundations, play a distinctive, and often unique, role in our society. They engage in those activities which business can not effectively carry out because profit is an insufficient motive for such activities (e.g., religion, education, health). And they represent desirable alternatives to government carrying on the same activities because the activities call for private freedom (e.g., religion, social science, research) or private initiative and experimentation.
- G. Major problems relate to the issues of private means and public ends pursued by foundations.
- 1.—Public ends. Should the government restrict those ends which foundations may pursue?
  - 2.—Current restrictions on pending legislation on legislative and electoral activities.
  - 3.—Private means—Experience with abuses.
    - a.—Self-dealing
    - b.—Accumulation of income
    - c.—Ownership of business
    - d.—Perpetuation of foundation management.

### III. Types of Foundations.

Foundations may be grouped in *six main classes*. Separation is not too sharp; a particular foundation may change in character and program through the years, and at a given period exhibit characteristics of several of the types. The division into the following six classes is chiefly for purposes of description and convenience.

#### 1. *General Research Foundations.*

This classification includes nearly *all the larger*, well-known Foundations. These include such famous names as the Rockefeller Foundation, Ford Foundation, Carnegie Corporation of New York, Commonwealth Fund and many others. They operate under broad charters. They support the research projects in health, welfare, and education which characterize foundation work in the public mind.

Although the foundations that can now be classified as "general research" probably do not exceed 150 in number, they control more than half the assets of all foundations, and are the ones most in the public eye. To a larger degree they are the leaders and standard-setters for the foundation movement.

#### 2. *Special Purpose Foundations.*

They are created, many of them by will or trust instrument rather than incorporation, to serve a charitable purpose closely detailed, usually in the charter or at least in a letter of gift.

Most special purpose funds are small, but a few have large endowments. *The Edward Drummond Libbey Trust* has an endowment of nearly \$16 million; all its net income is paid to the Toledo, Ohio Museum of Art by terms of the will. *The Juilliard Musical Foundation* devotes income from funds currently worth more than \$16 million primarily to the support of the Juilliard School of Music in New York City.

#### 3. *Family or Personal Foundations.*

Typically, family foundations are set up by a living person or persons rather than by bequest. The same high tax rates in the upper brackets which now tend to prevent large accumulations of wealth have encouraged, through the provisions for charitable deductions, annual contributions to family foundations. Generally, they are small; and may have no administrative organization or headquarters other than the office of the donor, or of a law firm. Such foundations have many legitimate and useful purposes. They may serve as a *buffer* between the giver and the numerous appeals directed to him, permitting time for investigation and planned giving. They may help to level the rate of ordinary giving as between years of high and low income, or

they may serve as a reservoir for the accumulation of substantial funds needed for a major project.

Many family foundations serve simply as *the channel* for the current giving of the living founder. Their programs differ little from the giving of wealthy men and women who have not incorporated their charity. Their beneficiaries probably include the local community chest, hospitals, a few national drives, the donor's college, possibly his church (such giving is more often done personally), and perhaps one or several pet projects.

The secrecy which shrouded the operations and even the existence of many of these foundations, and several examples of undoubted abuse, have cast some shadow upon them, and upon foundations in general. During and just after World War II some such foundations were organized primarily to *take advantage of loopholes in the tax laws, and had little or no program for social betterment*. The Revenue Act of 1950, however, required public reporting, spelled out certain "prohibited transactions" which would result in loss of tax exemption, forbade "unreasonable" accumulations by exempt organizations, and by these and other provisions halted the most severe abuses. Intended and legitimate tax advantages still remain.

Foundations of the family type, beginning with limited purposes and perhaps small funds, sometimes have grown into the general research class. The example of the Carnegie Foundation's shift in program has been cited. The Ford Foundation, largest of them all, began with many of the characteristics of a family foundation.

The Rockefeller Brothers Fund is an example of a foundation that has grown large, but intentionally retains some of the giving characteristics of a family foundation. It was established in 1940 by the five Rockefeller brothers, David, John, Lawrence, Nelson and Winthrop. To assist in expansion of the Fund's program, John D. Rockefeller, Jr. donated \$58 million to the corpus in the period 1951-1953.

#### 4. *Corporation Foundations.*

A wave of foundations of a new type has sprung up in the past twenty years. These are corporation foundations, "*company*" foundations, trusts or funds—under any title, tax-exempt, non-profit legal entities separate from the parent company, but with trustee boards consisting wholly or principally of corporation officers and directors, and their purpose, facilitating corporation giving. Their full number is not known, but it is estimated they might total several thousand.

Corporation foundations differ in important aspects from other types. Unlike the great research foundations (but like many family foundations) they seldom have a substantial corpus, but are more nearly channels for current giving, with just enough reserves to level out the year of low income. However broad their charters, their programs seldom aim at "the welfare of mankind," but only the portion of that welfare that benefits the corporation, its employees, its stockholders, or its business relationships.

In closely held corporations, contributions may come from both the company and from officers and chief stockholders.

5. *Community Trusts.*

Community trusts are a special class of foundations concerned with problems of social welfare, but acting under community control in a sense seldom found in the usual philanthropic endowment.

6. *Governmental Foundations.*

These are foundations set up and controlled by the United States Government and financed by taxation. Science, education, and the arts have been areas favored for such enterprises. There have been many attempts to create such foundations, but the outstanding exception is the National Science Foundation, established in May, 1950, after several years of sharp debates. This foundation now has a budget greater than any but the two largest private foundations.

To illustrate the importance of the number of beneficiaries, we must distinguish between a gift for the benefit of all workers in a particular trade or industry which is a valid charity and a gift for the benefit of the workers of a particular company.

Benefiting the employees of a single or a limited number of corporations is not such a public purpose as to qualify as being charitable, but is considered as instrumental in gaining private economic success. The leading English case on this subject is *Oppenheim v. Tobacco Securities Trust Co.* in which the House of Lords held that a trust to provide for or assist "in providing for the education of children of employees or former employees" of a Tobacco Company was not a charitable trust. This was the holding despite the fact that education is clearly a charitable purpose and the corporation had over 110,000 employees. This is a valid and important distinction. Let us assume for the moment that the Ford Foundation had been established for the benefit of all children of present employees and/or former employees of the Ford Motor Company. The primary beneficiary of such a trust would be the Ford Motor Company since it would

be put in an advantageous position as compared with other automobile manufacturers. Large fringe benefits would be available to the Ford workers which would be unavailable at other companies. The ensuing worker satisfaction and reduced labor costs would be of immense competitive value to the Ford Company.

On the other hand, a charitable gift to benefit all workers in the automobile industry would not be of economic benefit to just one company but would leave all companies unchanged in their competitive relationships. In fact, where the gift is to all employees in a given industry, whatever advantage might result would be to the weaker companies whose employees would be more apt to be in need of charitable assistance.

A second objection to treating a trust for the benefit of a given company as a charity, such as noted in the *Oppenheim* case, is the possibly small size of the class. The court there would not accept the number of employees of the subject company, no matter how many, as qualifying as a charitable beneficiary.

#### IV. Organization of a Philanthropic Foundation.

##### A. *Foundation is a Charitable Trust.*

The foundation is a development of the Old English Law concept of a charitable trust. Basically, all philanthropic foundations are charitable trusts. They may be *inter vivos* created during the lifetime of a donor or testamentary by his will; and is distinguished from private trusts, they may exist in perpetuity. The foundation is a modern form providing endowment of a nonprofit enterprise and the setting up of a corporation or an association to carry out the originator's plans. Today, the foundation is an instrument for contributing private wealth to public purposes.

##### B. *Two Legal Forms—Trusts or Corporations.*

Foundations are usually created in one of two distinct legal forms: trusts or corporations. I might mention voluntary associations for charitable purposes are also recognized in law, but this form is rarely employed. The historical roots of the laws relating to charities are to be found in the law of trusts as it developed in the Courts of Chancery in England. This is a well defined body of law, of which the law of charitable trusts forms a part.

As you know, a trust is a device for making disposition of property whereby the legal title and the duties of management are given to a trustee who is charged with managing the prop-

erty and applying it for the benefit of named beneficiaries. The right to enjoyment or the beneficial interest in the property belongs to the beneficiaries, the *cestui qui trustants*, who can enforce their rights against the trustee (or trustees) and the donor through appropriate court actions.

Most foundations are set up in charitable trust form. That is, the grantor of the endowment, by a deed of trust conveys money or property to a named trustee (or trustees) to be disbursed as directed in that document. Such a trust differs from a private trust in that the beneficiaries are not named individuals, but are members of a specific group or class of persons, indefinite in number, or of the public generally which qualify for the charitable purpose.

### C. *Requisites for Creation of a Charitable Trust.*

There are three requirements for creating a charitable trust: (1) *res*, (2) intention, (3) purpose: There must be property that is to become the subject matter of the trust; evidence of an intention to create the trust; and devotion (or dedication) to a purpose that the courts of the state where the trust is created will recognize as charitable.

Any kind of property can be the trust *res*.

The evidence required to establish an intent to create a charitable trust is usually a written instrument or trust indenture. A written instrument may be required by law if the subject matter of the property is land and if the state where the land is situated has enacted the Statute of Frauds requiring all transfers of land to be in writing. Aside from this, there is no need for a written instrument, just as there is no need for consideration.

An individual may create a charitable trust by declaring orally that he holds certain property as trustee for the benefit of some specific charitable purpose. This is rarely done, however, since the problem of proof is often difficult, particularly in connection with tax questions; and a donor will usually desire to specify provisions for its implementation.

As you can see, foundations as charitable trusts are relatively easy to establish. Usually all that is required is the creation of a trust by deed or will or a nonprofit corporation, both of which could be administered by the donor and members of his family or close associates.

The charitable foundations, in their beginning in this country, had few legal requirements. The Internal Revenue Code and Treasury rulings and Court decisions have made them a matter of great public concern. In many states a duty is placed



on testamentary trustees to present accounts to the overseeing court at regular intervals for allowance.

In the present tax climate, with concern for reform, we might anticipate an enlargement of interest in foundations as a source of tax income from registration fees, supervision charges, etc.

Once created, the foundation will attempt to qualify as a tax exempt organization by filing with the Internal Revenue Service. This status has two main consequences: The income earned by the foundation on its investments is tax exempt and donations to it are deductible by the donor for his federal income, estate and gift taxes. The donor's ability to contribute substantial wealth to a foundation, receive a tax deduction for his contribution, and still maintain control of his wealth through control of the foundation for an indefinite period of time, has been the key factor in the rapid growth of these foundations. By maintaining control of the foundation, assets which would otherwise be paid as taxes, can remain under family domination for generations. The earnings of the foundation, being tax free, can accumulate and grow much faster than those of businesses whose earnings are subject to diminution by taxes. The cumulative effect of foundations used in this manner is to perpetuate the concentration of wealth and economic control.

Some commentators contend that the idea of benefiting the general public by relieving the Government from some of its functions and responsibilities is being perverted for private benefits to the settlor or the non-charitable objects of his bounty.

Congressman Patman periodically singles out cases of abuses and causes a great clamor. See the other articles in this Symposium regarding the effects of the 1969 Tax Reform Act on these abuses.

## **V. Setting up a Foundation.**

In summation we see that foundations may be set up by an individual, a family, a corporation, or any combination of these. When a decision has been reached to set up a foundation, certain choices must be made.

It is important to give careful attention to the drafting of the trust deed. Bearing in mind the essentials of a charitable trust, consideration must be given to the following elements of the trust instrument:

1. Selection of a name
2. Drafting of a purpose clause or declaration of purpose
3. Transfer of property clause

4. Covenants by trustee
5. Revocability provision
6. Successor trustee
7. Acceptance of trust
8. General provision
9. Execution
10. Appendix
11. Compliance with state and Federal Laws and Regulations.

1. *Significance of Name.*

The name is not decisive. Variant names under which foundations have appeared include: The Rockefeller *Foundation*, the Carnegie Corporation of New York, Smithsonian *Institution*, Duke *Endowment*, Commonwealth *Fund*, etc., etc.

The name *foundation* has been adopted by many organizations which fall outside our definition and have no proper right to its use. They include agencies which solicit contributions instead of disbursing from a special fund, and some which are trade associations, pressure groups, or outright rackets.

2. *Drafting of Purpose Clause.*

This clause should clearly declare the purpose of the foundation. A general declaration is made to the effect that the settlor intends the trust to be used for the "*betterment of mankind.*" This is followed by more specific provisions designating the purposes in greater detail—for eleemosynary or charitable purposes.

3. *Transfer of Property Clause.*

This clause will declare and describe the property being conveyed to the foundation. The several items of property should be listed on a schedule or appendix which would be attached to the trust deed.

4. *Covenants by Trustees.*

The trustees are bound to fulfill their obligations to carry out the intentions of the settlor.

5. *Revocability Provision.*

The settlor may desire that the trust be irrevocable. It may also provide that none of the terms or provisions may be altered, amended or revoked in any particular.

6. *Successor Trustees.*

This provision usually binds successor trustees to the terms and limitations applying to the original trustees.

7. *Acceptance of Trust.*

In this provision, each trustee accepts the trust property subject to the terms, conditions, and obligations incident thereto.

### 8. *General Provisions.*

In this section provision is made for the filling of a vacancy among the trustees; retention of funds by trustees; perpetual existence may be authorized; an annual report may be required; in addition to their specific and general powers, the trustees may be vested with "all such other powers as may be necessary and appropriate to the proper carrying out of the provisions of the deed of trust." Lastly, you may provide that the provisions of the deed are severable and provide that if any are held to be invalid, those remaining "shall not be affected thereby."

### 9. *Execution.*

This is the usual formal provision for this purpose executed by the settlor and can set forth that the trustees acknowledge "our promises, covenants and agreements herein contained and in witness of our acceptance of the property herein described."

### 10. *Schedule or Appendix.*

This would list the original property transferred to the trust.

### 11. *State Registration.*

A few states require registration and payment of fees, and detailed information. Massachusetts in particular regulates and supervises more diligently than other States. We mentioned that charitable status is governed by State law, and the exemption granted under Federal Law and regulations. In most cases where a federal tax exempt status is attained, the State will follow in granting its own tax exemption. If the Federal exemption status is revoked, the State will usually likewise revoke the tax exempt status.

## **VI. Operation of a Philanthropic Foundation.**

Once the trust is created, the *res* conveyed or delivered to the trust, and the terms of the trust accepted by the trustees, it is then in a position to operate. If the trust uses the corporate form, it must obtain a charter and comply with statutory provisions governing such corporation.

The first step will be to apply for and obtain tax-exempt status by applying to the Internal Revenue Service. Once this status is obtained the state follows and also recognizes the tax-exempt status.

Once the foundation or trust has obtained its federal tax-exempt status, it may be required to submit registration forms and detailed information to the proper state authority, usually the attorney general. This is governed by the laws of the domicile of the trust.

The trustees or managers, as you may call them, in accepting this position do covenant and are obligated to perform in the confines of the trust purposes and other provisions. They may distribute assets for charitable purposes or invest the assets and distribute the resulting net earnings.

The trust property may include cash, businesses, or stock in corporations. The instrument may provide for the manner of management of the trust res by the trustees, distribution of income for certain charitable purposes and voting of corporate stock and other problems to be handled by the trustees. The trustees may be empowered to organize or engage outside advisors or committees to effectuate the purposes at hand and the projects which it may from time to time consider.

It is to be noted that trustees may be personally liable for losses due to lack of reasonable care, diligence and prudence and exculpatory clauses relieving the trustees are against public policy and void.

The duties of the trustees although set forth in the trust instrument may also be specified, enlarged and imposed by statute.

The trustees may not delegate to others the doing of acts which they can reasonably be required to perform. A trustee may delegate administrative tasks to others, may employ attorneys, advisors, accountants or stock brokers and may entrust them with property but he must maintain at all times responsibility for their acts.

The trustees are under a duty to keep and render clear and accurate accounts as to the administration of the trust, and to furnish accurate information to the beneficiary, which may be the general public through the attorney general.

There may be statutory requirements governing the investments the trustees may make. Thus it might be considered improper for the trustees to invest in speculative investments. If the trust instrument gives the trustees discretion "as they deem advisable,"—the effect of such a clause will depend on the tradition of the state. Usually, the prudent man rule will be applied. Accordingly, investments should be diversified.

The basic duties of the trustees are loyalty, diligence, care and prudence, which are imposed in addition to those that are specifically set forth in the trust instrument. The trustees are under a positive duty to administer the trust, take and keep control of the property, preserve the property, enforce claims, defend actions and keep the trust property productive.

At any time that the trustees are in doubt as to their powers to sell or mortgage or make long term leases, for instance where the subject matter is land and the power cannot be inferred expressly or by implication from the trust instrument, it would be wise for the trustees to obtain a court order, in which case the attorney general is ordinarily a necessary party to the suit.

Some states have adopted the Uniform Acts governing the administration of charitable trusts. These include California, Illinois, Michigan and Oregon.

Unless the instrument provides otherwise, decision of a majority of the trustees governs. This is different than in a private trust whose

powers can be exercised only with the concurrence of all the trustees. A trustee who refuses to join with the majority in an action that constitutes a breach of trust is not liable for the consequences of the majority actions, but he may have a duty to apply to the court to prevent the action through the attorney general.

The question of liability to a third party may arise. Formerly the trustees were personally liable for all obligations arising out of either contracts or torts made in the course of administration. If the trustee was not personally at fault, he was entitled to repayment or indemnity, from the trust estate, but the legal actions had to be brought against the trustee. More recently, the courts have relaxed this view, so that it is possible under many circumstances for a plaintiff to bring an action directly against the trust estate. A provision in the instrument or a statement to the general effect that the trustee "shall not be liable for anything except his own personal and wilful default or misfeasance" will relieve the trustee but courts require that the other party to any contract have notice of the provision.

As to torts during the administration of the trust, the trustee's liability will depend on whether the trustee was personally at fault. In many states, charitable immunity has been revoked and recovery is allowed directly against the trust estate.

As to compensation of trustees, it is customary for corporate trustees to be compensated at a rate comparable to that of trustees of a private trust. As a general rule, however, trustees of charitable foundations do not receive compensation other than reimbursement for expenses. Very few of the smaller family foundations pay compensation to trustees—and thus avoid suspicion that the foundation is a device for channeling tax-exempt income to family members or friends of the donor.

## VII. *Cy Pres*.

It sometimes occurs that the purpose of the charitable trust becomes obsolete or not feasible.

The *cy pres* doctrine is now generally accepted as part of the common law of the majority of the states. In absence of statute, the doctrine of *cy pres* is generally applicable only after three conditions have been met: (1) A valid charitable trust or a corporation that can be considered a valid charity must exist; (2) It must be impossible or impractical to carry out the donor's intention; (3) The donor must have had a general charitable intention as well as the intention to benefit that particular charitable object he designated.

Treasury Regulations require as a condition for exemption that upon dissolution or termination a foundation's assets must be distributed for one or more exempt purposes or turned over to a federal, state or local

government for public purposes. See Treas. Reg. sec. 1.501(c)(3)-1(b)(4).

To invoke the doctrine of *cy pres*, the trustees or the attorney general applies to the court for its permission or direction to deviate from the terms of the trust and to frame a scheme for the application of the property. The trustees or the attorney general often suggests a plan that the court may adopt. In complicated situations, the court may appoint a master who will hear all interested parties and submit a proposal to the court. The attorney general is a necessary party to these proceedings.

### VIII. Conclusion.

As lawyers we can anticipate much activity in new litigation challenging foundations for misuse and abuse of their privileged existence.

Foundations themselves must demonstrate their sense of responsibility to the public. The problem of accountability is of prime concern to all philanthropic foundations.

To accomplish these objectives we must, as Professor Sacks presented the question, search for the ideal methods for maintaining (what he calls) "the delicate balance of public ends and private means that is embodied in the charitable foundation."

It is of value to note the Reports of Congressman Patman. We must be mindful that the Report is not a document written by lawyers for lawyers and that it cannot, therefore, be tested in the first instance by the rigorous standards of precision and consistency demanded of lawyers. Yet he has served well in bringing foundations to public attention.

Indeed, as Professor Sacks observed, the issue of charitable giving is not an issue on which temperate, reasoned reactions have prevailed. Another serious crisis in the foundation field may move the public to destroy this form of charitable expression. We believe, therefore, that Representative Patman's Report should not be lightly or conveniently dismissed. The future of philanthropic foundations is pregnant with possibilities for abuse but concurrently with great opportunities for accomplishment for the good of all mankind. Otherwise, it is likely that the pressures causing the great clamor will continue until there is an improvement in regulation of the operations of foundations.

We are convinced that a proper approach to administrative supervision of foundations should begin at the state level. Charitable objects and purposes are traditionally a matter of state concern.

Let us hope that the law makers, the attorneys general and the courts will emphasize the primary importance of the public as the sole beneficiary of philanthropic trusts.

**IX. Recommended Readings and Source Materials.**

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