

# **TROUBLESOME TRUST TOPICS**

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## **CHAPTER 6**

The information set forth in this outline should not be considered legal advice, because every fact pattern is unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein. Nonlawyers are advised to consult an attorney before undertaking issues addressed herein.

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Member of the Dallas Bar Association; member of the Section of Taxation.  
2012 Dallas Non-Profit/Charities Law Lawyer of the Year, *The Best Lawyers in America*® by Woodward/White Inc.  
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Member, Board of Trustees, ChildCareGroup (1990-1996, 1997-2002); Chair (2001); Honorary Life Trustee.  
Member, Board of Directors (1990-1996) and Secretary (1990-1994), Dallas Child Guidance Clinic (now Child and Family Guidance Centers).  
Member, Board of Trustees, Dallas Children's Advocacy Center (1998-2004).  
Member, Board of Directors, Dallas Children's Advocacy Center Foundation (2002-2008), and President (2006-2007).  
Member, Board of Directors, Ronald McDonald House of Dallas, Inc. (2003-2009) and 2012- ).  
Member, Board of Trustees, The Catholic Foundation (2009-2013); Secretary (2012-2013).  
Secretary, Dallas Symphony Foundation (2010-2014).  
Member, Board of Trustees, The Brodsky Foundation (2012- ).  
Member, Endowment Committee and Advisory Board, The Crystal Charity Ball.  
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# TROUBLESOME TRUST TOPICS

## I. INTRODUCTION

### A. What is a Charitable Trust?

In the modern era of exempt organizations, the overwhelming majority of organizations are formed as nonprofit corporations. In 2005 it was estimated that of 650,000 recognized charities only 12,422 were trusts. See Evelyn Brody, *Charity Governance: What's Trust Law Got to Do with It?*, 80 Chicago-Kent L. Rev. 641, n. 1 (2005).

At its simplest, a charitable trust is a fiduciary relationship with respect to property whereby property is held in trust for charitable purposes. The Restatement of Trusts describes it as a “fiduciary relationship with respect to property arising as a result of the manifestation of an intention to create it, and subjecting the person by whom the property is held to equitable duties to deal with the property for a charitable purpose.” Restatement of Trusts § 348. Texas law defines a charitable trust as “a charitable entity, a trust the stated purpose of which is to benefit a charitable entity, or an inter vivos or testamentary gift to a charitable entity.” Tex. Prop. Code § 123.001(2). Charitable trusts are the oldest form of nonprofit “entity” tracing their roots back to the Statute of Charitable Uses of 1601. 43 Elizabeth, Chapter 4 (England 1601).

This paper will refer to charitable trusts as an “entity” and discuss using the charitable trust “form.” However, a charitable trust is not, in truth, an entity for state law purposes. Rather, it is a fiduciary relationship with respect to property. This becomes clear in the litigation context where the trust is not a proper party to litigation; rather, the trustee is the proper party. See *Huey v. Deshazo*, 922 S.W.2d 920, 926 (Tex. 1996). Likewise, as will be discussed below, the trustee does not owe duties to the trust in the way that a director owes duties to a corporation. Instead, the trustee owes duties to the charitable purpose and to the beneficiaries (either specified or the public). See *Alpert v. Riley*, 274 S.W.3d 277, 291 (Tex. App.—Houston [1st Dist.] 2008, pet. denied); Tex. Prop. Code § 113.051.

### B. Is a Nonprofit Corporation Effectively a Charitable Trust?

Because tax exemption rests in the first part on being organized for an appropriate tax-exempt purpose (be it charitable or social), these organizations more specifically identify their purposes in their governing documents compared to for profit businesses, which may be organized to conduct all lawful operations of whatever kind or nature. One court has noted the

distinction, stating that “[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the *raison d’être* of the organization.” *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 595 (Sup. Ct. 1999). With the additional level of specificity as to purpose, the decision maker faces a more defined realm of permissible actions. That realm can be even more narrowly defined when funds are raised for specific purposes.

The question that then arises is whether a nonprofit corporation is, effectively, a charitable trust. Texas law does provide that a gift to a charity is deemed to be held in trust. See *Blocker v. State*, 718 S.W.2d 409, 415 (Tex. App. – Houston [1st Dist.] 1986, writ ref’d n.r.e.). However, this language does not mean that an express trust subject to the provisions of the Texas Trust Code springs into existence whenever a gift is made to a charity.<sup>1</sup> In fact, Section 22.223 of the Texas Business Organizations Code (the “TBOC”) expressly negates such a reading of *Blocker*. Rather, the donation is “impressed with a charitable trust,” which highlights the role of the Office of the Texas Attorney General (the “OAG”). The OAG’s standing arises from the OAG’s role as the representative of the public interest in charity. See Tex. Prop. Code § 123.001, *et. seq.*<sup>2</sup> The OAG is charged to ensure that charitable assets are used for appropriate charitable purposes and in accordance with any gift restrictions. Furthermore, even if an express trust were created, the Texas Trust Code (unlike the Uniform Trust Code) does not expressly provide for donor standing to enforce the terms of a restricted gift.

Notwithstanding that a nonprofit corporation is not an express trust, certain principles inherent in trust law do apply. Because the duty of obedience requires pursuit of the mission of the organization and protection of charitable assets, it is clearly important to understand the purposes of the organization. In the context of a nonprofit corporation, the purpose is stated in the organization’s governing documents (Articles of Incorporation/Certificate of Formation/Bylaws) and may be amplified by other documents such as testamentary documents directing the creation of the organization, the application for exempt status filed with the Internal Revenue Service or solicitations for

<sup>1</sup> See, e.g., In *Dodge v. The Trustees of Randolph-Macon Women’s College*, the claimants (alumni and donors of the college) sought to establish standing arguing the restricted gift resulted in the creation of a charitable trust and they were the beneficiaries. *Dodge v. The Trustees of Randolph-Macon Women’s College*, 661 S.E.2d 805 (Va. 2008). The claimants were ultimately unsuccessful.

<sup>2</sup> The Financial Litigation, Tax and Charitable Trusts Division of the OAG is responsible for matters involving charitable organizations.

contributions. Each of these sources should be consulted though the basic statement of purpose in the Articles of Incorporation/Certificate of Formation should be given primacy.

An initial question is what purposes must be followed – the purposes at the time the gift was given, or the purposes as they may be changed by amendment to the governing documents of the corporation from time to time? Professor Johnny Rex Buckles, a leading commentator in this area, refers to the difference between these two positions as static charter fidelity (adhere to the purposes as they existed at the time of the gift) and dynamic charter fidelity (adhere to the purposes as they may be changed from time to time). See Johnny Rex Buckles, *How Deep are the Springs of Obedience Norms that Bind the Overseers of Charities?*, 62 Cath. U. L. Rev. 913, 921-22 (2013). The debate is more intense in the context of charitable corporations as compared to trusts because unlike the majority of charitable trusts, charitable corporations organized under Texas statutory law (historically the Texas Nonprofit Corporation Act and now the Business Organizations Code) are generally empowered to amend their governing documents. This power to amend (which does not generally require judicial action, notice to the OAG or other government oversight) arguably presupposes the power to change the purposes of the corporation. At least one Texas case has held in accord. See *The City of Hughes Springs v. Hughes Springs Volunteer Ambulance Service, Inc.*, 223 S.W.3d 707 (Tex. App.—Texarkana 2007, no pet.). In *Hughes Springs*, the Texarkana Court of Appeals considered the ability of a nonprofit corporation to change its purposes (without judicial or OAG oversight) to purposes more readily carried out. The City of Hughes Springs (which was to receive the assets of the nonprofit upon dissolution) argued the directors should not be able to change the purposes. The court recognized the power of the directors under statutory law to amend the purposes and the corporation thus survived with amended purposes.

While *Hughes Springs* represents the views of only one appellate court, its rationale is sound and no other Texas case that would prohibit a nonprofit corporation from amending its purposes so long as the purposes remain charitable in nature.<sup>3</sup> However, this power to amend purposes only raises a second question – can assets donated to a charitable corporation with specific purposes be redeployed in furtherance of purposes amended after receipt of the donation. Stated differently, does the donation of assets to a charitable corporation with specific purposes set out in its governing documents operate to restrict those donated

assets for use only for the purposes existing at the time of the donation? Again, while there is academic debate on the subject, Texas law is sparse. The primary Texas case cited with respect to this question is *Blocker v. State*, 718 S.W.2d 409 (Tex. App.—Houston [1st Dist.] 1986, writ ref'd n.r.e.). The *Blocker* court held that “the acceptance of such assets from donors established a charitable trust for the declared purposes [i.e. the purposes existing at the time of the donation as set forth in the recipient corporation’s governing documents] as effectively as though the assets had been accepted subject to an express limitation providing the gift was held in trust solely for such charitable purposes.” *Id.* at 415. In the event a charity has always been formed and operated for a specific purpose and the charity has raised funds for its operations, careful consideration should be undertaken of the ability to redeploy those assets post conversion and a review of then-current case law should be performed.

## **II. MODIFICATION PROCEEDINGS: APPLICABLE STANDARDS OF LAW AND JUSTIFICATION**

### **A. Judicial Modification**

When the terms of a charitable trust or a restriction cannot be fulfilled, or in the event a charity desires to seek modification of such terms or restriction, the charity should first understand the genesis of the restriction because restrictions arising as a result of the charity’s organizational documents offer different considerations.

With respect to restrictions arising from a written statement of intent from the donor or as a result of a solicitation campaign, the threshold question is whether the restriction is on an institutional fund or a program-related fund.<sup>4</sup> Charities seeking release or modification of institutional funds will look to rules provided by the Texas Uniform Prudent Management of Institutional Funds Act (“UPMIFA”). Charities seeking release or modification of program-related funds will look to the doctrines of *cy pres* and equitable deviation.<sup>5</sup>

<sup>4</sup> This discussion assumes the charity is a nonprofit corporation and therefore subject to UPMIFA, or a charitable trust to which UPMIFA applies.

<sup>5</sup> There is some debate about whether such an action would be brought under the common law or under Section 112.054 of the Property Code (on the basis that restrictions results in assets being impressed with a charitable trust). Under either circumstance the standards are the same; however, under Section 112.054, the petitioner may seek reasonable and necessary fees in bringing the action under Section 114.064. At the same time Section 163.011 of UPMIFA specifies that the Texas Trust Code does not apply to any institutional fund governed by UPMIFA.

<sup>3</sup> Cf. *Blocker v. State*, 718 S.W.2d at 415 (prohibiting amendment that would have allowed distribution to individuals).

Traditionally, the only way to alter or remove the restrictions was through application of the *cy pres* doctrine. The doctrine applies where a donation is made with general charitable intent, that is, an intent that the funds be devoted to a more general charitable purpose than the specific purpose serving as the basis of the restriction. Where the donor manifests general charitable intent, a court may direct use of the funds to purposes as similar as possible to the initial purposes when the initial purposes are or become impossible, impracticable, or illegal. See Restatement (Second) of Trusts § 399 (1959); see also Tex. Prop. Code § 112.054; Johnny Rex Buckles, *When Charitable Gifts Soar above Twin Towers: A Federal Income Tax Solution to the Problem of Publicly Solicited Surplus Donations Raised for a Designated Charitable Purpose*. 71 Fordham L. Rev. 1827 (2003). For example, if a founder had created a foundation for the purpose of funding research to find a viable vaccine for polio, the foundation’s purpose would have been achieved in 1955 through the work of Jonas Salk. In such event, the purpose would need to be modified. If a founder created a foundation for a purpose that has subsequently been deemed unlawful, in such event the purpose would need to be modified. If a gift was made with a restriction that can no longer be honored, the gift restriction would need to be modified. In these instances, the intent behind the founding/donation should be followed while making a modification to the purpose to make it as near as possible the original purpose. Importantly, a restrictive purpose does not fail merely because it is not “efficient” to continue it.

*Cy Pres* applies to use of the donated funds. A similar doctrine, equitable deviation, applies to modification of administrative terms of a gift when the terms as imposed are or become impossible or illegal, or where compliance would *substantially* impede the accomplishment of the purposes of the gift due to circumstances not anticipated by the donor. See Restatement (Second) of Trusts § 381; see also Tex. Prop. Code § 112.054.

Application of *cy pres* and equitable deviation is restrictive as both necessitate a finding of related to the difficulty of following the restriction (*cy pres*: carrying out the designated purposes of the gift is, or has become impossible, impracticable, or illegal).

**B. Parties Who May Bring a Construction, Modification or Termination Action**

Section 112.054 provides that a trustee or beneficiary may commence an action under that section. The term “beneficiary” is extremely broad under the Texas Property Code. Section 111.004 of the Texas Property Code defines “beneficiary” as a person for whose benefit property is held in trust, regardless of

the nature of the interest. As such, contingent or remainder beneficiaries may bring an action to modify or terminate a trust. Any interested person may commence an action under Section 115.011, the general jurisdictional statute for trusts in the Texas Property Code. With respect to charitable trusts, the trustee(s) will be proper parties to bring an action, as will the OAG, as the representative of the public’s interest in the charity. To the extent there is an ascertainable beneficiary, the beneficiary will also be a proper party to commence an action. Otherwise, purely charitable trusts do not have other “interested persons”. Importantly, when drafting a construction and/or modification petition, the trust should not be a party. The trust does not have capacity to sue or be sued because term “trust” refers not to a separate legal entity, but rather to the fiduciary relationship governing the trustee with respect to the trust’s property. See *Huey v. Deshazo*, 922 S.W.2d 920, 926 (Tex. 1996). Rather, suits against a trust are to be brought against its legal representative, the trustee. See *The Ray Malooly Trust v. Juhl*, 186 S.W.3rd 568, 570 (Tex. 2006).

**C. Necessary Parties That Must Be Joined**

Section 115.001(b) of the Texas Property Code identifies necessary parties to proceedings concerning trusts. That statute provides that the trustee and the beneficiary will always be necessary parties. This is true even if the beneficiaries are not receiving distributions at the time the action is filed; however, contingent beneficiaries that are designated as a class are not necessary parties. In addition, Sections 115.011(c) and 123.002 of the Texas Property Code provide that the OAG as a proper party may intervene in proceedings involving a charitable trust, as discussed above. As such, while the OAG is not a “necessary party,” the OAG must be given notice and the option to intervene in the proceeding to avoid the running the risk of having a settlement agreement or judgment set aside.

Section 123.003(a) of the Property Code provides that when a charitable trust is involved, the party initiating the proceeding “shall give notice of the proceeding to the [OAG] by sending to the [OAG], by registered or certified mail, a true copy of the petition or other instrument initiating the proceeding involving a charitable trust within 30 days of the filing of such petition or other instrument, but no less than 25 days prior to a hearing in such a proceeding.”

Section 123.003(b) requires additional notice to the OAG if an amended pleading is filed “which adds new causes of action or additional parties to a proceeding involving a charitable trust in which the [OAG] has previously waived participation or in which the [OAG] has otherwise failed to intervene.” In such

an event, the notice requirements in Section 123.003(a) must be met.

The party or the party’s attorney must execute and file in the proceeding an affidavit stating the facts of the notice and must attach to the affidavit the customary postal receipts signed by the OAG or an assistant OAG. Tex. Prop. Code Ann. § 123.003(c).

Unlike suits to construe, modify or terminate private trusts, it is not typically necessary to have ad litem appointed or utilize the doctrine of virtual representation in most circumstances when dealing with charitable trusts. It is unusual to have a need for a guardian ad litem or the application of the doctrine of virtual representation with respect to purely charitable trusts, as the OAG represents the public’s interest in the charity (i.e., unascertainable beneficiaries) and there are no minor, incapacitated, unborn, or unascertained individual beneficiaries. However, with respect to split interest trusts, there could be instances in which an ad litem could be appropriate or virtual representation could apply. In such instances, the practitioner should consult Section 115.013 (virtual representation) and Section 115.014 (ad litem).

**D. Jurisdiction**

In the trust construction, modification, or termination context, subject matter jurisdiction is conferred by the Property Code and the Probate Code. The Property Code, as detailed below, vests district courts with exclusive jurisdiction over trust issues. The Texas Probate Code vests the statutory probate courts with concurrent jurisdiction with the district court in all actions involving inter vivos trusts, charitable trusts and testamentary trusts, and now grants jurisdiction upon county courts in counties with no statutory probate courts to hear matters involving the interpretation and administration of an inter vivos or testamentary trust so long as the matter is related to a probate proceeding.

1. Jurisdiction Under the Property Code

Section 115.001 of the Property Code provides that a district court has original and exclusive jurisdiction over all proceedings by or against a trustee and all proceedings concerning trusts, including proceedings to: (1) construe a trust instrument; (2) determine the law applicable to a trust instrument; (3) appoint or remove a trustee; (4) determine the powers, responsibilities, duties, and liability of a trustee; (5) ascertain beneficiaries; (6) make determinations of fact affecting the administration, distribution, or duration of a trust; (7) determine a question arising in the administration or distribution of a trust; (8) relieve a trustee from any or all of the duties, limitations, and restrictions otherwise existing under the terms of the trust instrument or of this subtitle; (9) require an

accounting by a trustee, review trustee fees, and settle interim or final accounts; and (10) surcharge a trustee.

However, the Property Code points out that this list is not exhaustive. A district court has exclusive and original jurisdiction over a proceeding by or against a trustee or a proceeding concerning a trust whether or not the type of proceeding is specifically listed in Section 115.001. Section 115.001(d) of the Property Code sets out that the exceptions to a district court’s exclusive jurisdiction are: (1) when jurisdiction has been conferred by law on a statutory probate court; (2) a court that creates a trust under Section 867 of the Probate Code; (3) a court that creates a trust under Section 142.005 of the Property Code; (4) a justice court under Chapter 27 of the Government Code; or (5) a small claims court under Chapter 28 of the Government Code.

2. Jurisdiction Under the Probate Code

The 2009 Legislature undertook a complete overhaul of the probate jurisdiction statutes. Jurisdiction is now based on whether a matter is a “probate proceeding” or a “matter related to a probate proceeding.” Nevertheless, jurisdiction under the Probate Code still provides broad authority to statutory probate courts by allowing such courts to hear matters involving any trust. The significant change is that now constitutional county courts and county courts at law in counties with no statutory probate courts may hear trust matters, but only if the trust matters relate to a probate proceeding.

a. *Jurisdiction of Statutory Probate Court*

Section 4G of the Probate Code now provides that in a county in which there is a statutory probate court, the statutory probate court has jurisdiction of: (1) an action by or against a trustee; (2) an action involving an inter vivos trust, testamentary trust, or charitable trust; (3) an action against an agent or former agent under a power of attorney arising out of the agent’s performance of the duties of an agent; and (4) an action to determine the validity of a power of attorney or to determine an agent’s rights, powers, or duties under a power of attorney.

Section 4H of the Probate Code now provides that a statutory probate court has concurrent jurisdiction with the district court in: (1) a personal injury, survival, or wrongful death action by or against a person in the person’s capacity as a personal representative; (2) an action by or against a trustee; (3) an action involving an inter vivos trust, testamentary trust, or charitable trust; (4) an action involving a personal representative of an estate in which each other party aligned with the personal representative is not an interested person in that estate; (5) an action against an agent or former agent under a power of attorney arising out of the agent’s performance of the duties of an agent; and (6)



an action to determine the validity of a power of attorney or to determine an agent’s rights, powers, or duties under a power of attorney.

*b. Jurisdiction of Constitutional County Courts and County Courts at Law*

As noted above, constitutional county courts and county courts at law in counties with no statutory probate courts may now hear trust matters if the matters relate to a pending probate. Section 4A of the Probate Code provides that all probate proceedings must be filed and heard in a court exercising original probate jurisdiction. Also, Section 4A provides the court exercising original probate jurisdiction with jurisdiction of all matters “related to the probate proceeding” as specified in Section 4B of the Code. With the addition of this language, the definition of “probate proceeding” and “related to the probate proceeding” become important when determining jurisdiction.

Section 3(bb) of the Probate Code provides that a “probate proceeding” means “a matter or proceeding related to the estate of a decedent and includes: (1) the probate of a will, with or without administration of the estate; (2) the issuance of letters testamentary and of administration; (3) an heirship determination or small estate affidavit, community property administration, and homestead and family allowances; (4) an application, petition, motion, or action regarding the probate of a will or an estate administration, including a claim for money owed by the decedent; (5) a claim arising from an estate administration and any action brought on the claim; (6) the settling of a personal representative’s account of an estate and any other matter related to the settlement, partition, or distribution of an estate; and (7) a will construction suit.

Section 4B defines a “matter related to a probate proceeding” based upon the court system within a particular county (*i.e.*, whether the county has a statutory probate court, county court at law exercising original probate jurisdiction, or no statutory probate court and no county court at law exercising original probate jurisdiction). Additionally, by the Corpus Christi Court of Appeals held recently that the same analysis that applies to determine if a lawsuit is “incident” to an estate applies to determine if a lawsuit is “related” to an estate. *See In re Frank Schuster Farms, Inc.*, 2010 WL 2638481, \*6 (Tex. App.—Corpus Christi 2010, no pet. his.).

The revisions to the Probate Code now allow a trust construction/modification to be heard in the same court as a probate proceeding in certain circumstances. While constitutional county courts and county courts at law may now hear a trust construction/modification action so long as it is related to a probate proceeding, only a statutory probate court may hear matters

involving a trust, whether or not it is related to a pending probate proceeding.

**E. Applicable Law**

Both of the common law doctrines of *cy pres* and equitable deviation have been codified as part of the Texas Trust Code. Section 112.054 covers judicial modification of charitable trusts (in addition to private trusts) and as such *cy pres* or equitable deviation actions are brought pursuant to Section 112.054. On the other hand, if a named charitable beneficiary of a trust fails (for example, does not exist when the charitable interest in the trust vests, ceases to exist during the term of the trust, or ceases to be a charitable entity during the term of the trust), the trust instrument controls the naming of a successor charitable entity. If no provision exists for replacing a failed charitable beneficiary, the trustee may select one or more replacement charitable beneficiaries having the same or similar charitable purpose as the failed charitable beneficiary. *See* Tex. Prop. Code § 113.026. While no judicial action is required, to the extent the settlor is living and not incapacitated and the trustee and settlor cannot agree on the selection of a replacement charitable beneficiary, notice is to be given to the OAG, who is to refer the matter to the district court in the county in which the trust was created for the selection of a replacement charitable beneficiary. *See* Tex. Prop. Code § 113.026(g).

Modification and/or termination of a charitable trust is governed by the Texas Trust Code. When drafting a petition to modify or terminate a trust, the practitioner must comply with Section 112.054 (or if the trust is uneconomical, Section 112.059) of the Property Code.

Section 112.054 provides as follows:

(a) On the petition of a trustee or a beneficiary, a court may order that the trustee be changed, that the terms of the trust be modified, that the trustee be directed or permitted to do acts that are not authorized or that are forbidden by the terms of the trust, that the trustee be prohibited from performing acts required by the terms of the trust, or that the trust be terminated in whole or in part, if:

(1) the purposes of the trust have been fulfilled or have become illegal or impossible to fulfill;

(2) because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust;

(3) modification of administrative, nondispositive terms of the trust is necessary or appropriate to

prevent waste or avoid impairment of the trust’s administration;

(4) the order is necessary or appropriate to achieve the settlor’s tax objectives and is not contrary to the settlor’s intentions; or

(5) subject to Subsection (d):

(A) continuance of the trust is not necessary to achieve any material purpose of the trust; or

(B) the order is not inconsistent with a material purpose of the trust.

(b) The court shall exercise its discretion to order a modification or termination under Subsection (a) in the manner that conforms as nearly as possible to the intention of the settlor. The court shall consider spendthrift provisions as a factor in making its decision whether to modify or terminate solely because the trust is a spendthrift trust.

(c) The court may direct that an order described by Subsection (a)(4) has retroactive effect.

(d) The court may not take the action permitted by Subsection (a)(5) unless all beneficiaries of the trust have consented to the order or are deemed to have consented to the order. A minor, incapacitated, unborn, or unascertained beneficiary is deemed to have consented if a person representing the beneficiary’s interest under Section 115.013(c) has consented or if a guardian ad litem appointed to represent the beneficiary’s interest under Section 115.014 consents on the beneficiary’s behalf.

A petition under the Texas Property Code to modify or terminate a trust may be brought only by a trustee or a beneficiary. It is necessary to include one of the enumerated reasons in Section 112.054 within the petition, as the court is under no obligation to modify or terminate a trust simply because it is requested. The practitioner must undertake to plead and prove facts to show the merit/benefit/purpose of the requested relief.

Texas law also permits the termination of a trust that has become uneconomical to maintain due to its paucity of assets. Under Section 112.059 of the Texas Property Code, after providing notice to beneficiaries who are distributees or permissible distributees of the trust or who would be distributees or permissible distributees if the interest of the distributees or the trust were to terminate and no powers of appointment were exercised, the trustee of a trust with a total value of less than \$50,000 may terminate the trust if the trustee

concludes after considering the purpose of the trust and the nature of the trust assets that the value of the trust property is insufficient to justify the continued cost of administration.

In 2007, Texas adopted the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”) as Chapter 163 of the Texas Property Code. UPMIFA provides modern articulations of the prudence standards for the management and investment of charitable funds and for endowment spending. Additionally, UPMIFA address the release or modification of restrictions in certain cases with respect to “institutional funds.”

UPMIFA applies to Texas “institutions” managing “institutional funds” or “endowment funds”. “Institution” is defined to include: (1) a person, other than an individual, organized and operated exclusively for charitable purposes; (2) a government or governmental subdivision, agency or instrumentality, to the extent that it holds funds exclusively for a charitable purpose; and (3) a trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated. *See* Tex. Prop. Code § 163.003(4). “Institutional fund” means a fund held by an institution exclusively for charitable purposes. The term does not include: (A) program related assets; (B) a fund held for an institution by a trustee that is not an institution; or (C) a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund. *See* Tex. Prop. Code § 163.003(5). An endowment fund is defined as “an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment for its own use.” Tex. Prop. Code § 163.003(2). A “gift instrument” is defined by UPMIFA as a record or records, including an institutional solicitation, under which property is granted to, transferred to, or held by an institution as an institutional fund.” Tex. Prop. Code § 163.003(3).

UPMIFA permits release or modification of restrictions on institutional fund management, investment and/or purpose in limited circumstances. If the donor consents in a record, an institution may release or modify, in whole or in part, a restriction contained in a gift instrument on the management, investment or purpose of an institutional fund. A release or modification may not allow a fund to be used for a purpose other than a charitable purpose of the institution. Tex. Prop. Code § 163.007(a). Absent donor written consent, such as in the case of a deceased or unidentified donor, an institution may apply to a court for modification of a restriction on management or investment of an institutional fund, on the grounds of impracticability or wastefulness, if it impairs the

management or investment of the fund, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund, and the court may modify. To the extent practicable, any modification must be made in accordance with the donor's probable intention. Tex. Prop. Code § 163.007(b). An institution may apply to a court for modification of a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund, if such purpose or restriction becomes unlawful, impracticable, impossible to achieve, or wasteful, and the court may modify in a manner consistent with the charitable purposes expressed in the gift instrument. Tex. Prop. Code § 163.007(c). If an institution applies to a court for modification, Chapter 123 of the Texas Property Code applies (and therefore the AG must be notified in accordance with that chapter). *See* Tex. Prop. Code § 163.007(b) and (c).

For certain smaller and older funds, if an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution, 60 days after receipt of notice by the OAG, may release or modify the restriction, in whole or in part, if:

- The institutional fund subject to the restriction has a total value of less than \$25,000;
- More than 20 years have elapsed since the fund was established; and
- The institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument.

The notification to the OAG must be accompanied by a copy of the gift instrument and a statement of facts sufficient to evidence compliance with the requirements set out above. *See* Tex. Prop. Code § 163.006(d).

UPMIFA does not apply to trusts managed by corporate or individual trustees, but does apply to trusts managed by charities. A charity the governing instrument of which is a trust document (and the trustee of which is not a charity) is instead governed by the Texas Uniform Prudent Investor Act (located in Chapter 117 of the Texas Property Code) for investment and management issues.

### **III. WHEN IS COURT APPROVAL AND NOTICE TO THE OAG REQUIRED?**

In addition to investigative authority under various Texas statutes, Chapter 123 of the Texas Property Code specifically governs OAG participation in proceedings involving charitable trusts. As referenced above, for purposes of Chapter 123 the term

“charitable trust” means a charitable entity, a trust the stated purpose of which is to benefit a charitable entity, or an inter vivos or testamentary gift for a charitable entity. The phrase “proceeding involving a charitable trust” means a suit or other judicial proceeding the object of which is to:

1. Terminate a charitable trust or distribute its assets to other than charitable donees;
2. Depart from the objects of the charitable trust stated in the instrument creating the trust, including a proceeding in which the doctrine of *cy pres* is invoked;
3. Construe, nullify, or impair the provisions of the testamentary or other instrument creating or affecting a charitable trust;
4. Contest or set aside the probate of an alleged will under which money, property, or another thing of value is given for charitable purposes;
5. Allow a charitable trust to contest or set aside the probate of an alleged will;
6. Determine matters relating to the probate and administration of an estate involving a charitable trust; or
7. Obtain a declaratory judgment involving a charitable trust. *See* Tex. Prop. Code § 123.001(3).

With respect to this very broad list of proceedings involving a charitable trust, Chapter 123 provides that the OAG is a proper (although not necessary) party. Chapter 123 provides that the OAG must receive notice and have a right to intervene on behalf of the public. While Chapter 123 does not vest any substantive rights in the OAG, a judgment in a proceeding involving a charitable trust where the OAG is not given notice of the proceeding as required by Chapter 123 is voidable and may be set aside on motion of the OAG after the judgment is rendered. The same is true for a compromise, settlement agreement, contract, or judgment relating to a proceeding involving a charitable trust. To protect against the possible setting aside of a judgment, the party instituting a proceeding involving a charitable trust should ensure that notice is given as required by Chapter 123 and that the OAG has declined in writing to be a party to the proceeding or has approved and joined in the compromise, settlement agreement, contract, or judgment. *See* Tex. Prop. Code § 123.004.

### **IV. CHANGED CIRCUMSTANCES AND DONOR INTENT**

Sections 112.054(a) and (d) of the Texas Property Code provide in pertinent part that, “On the petition of a beneficiary, a court may order that... the terms of the trust be modified,... if... because of circumstances not known to or anticipated by the settlor, the order will

further the purposes of the trust;... or...the order is not inconsistent with a material purpose of the trust and... all beneficiaries of the trust have consented to the order....” Texas Property Code § 112.054(a)(5)(B), (d). Section 112.054(b) provides that the court is to exercise its discretion to order a modification or termination under Section 112.054(a) in a manner that conforms as nearly as possible to the probable intention of the settlor.

A modification under Sections 112.054(a) and (d) thus requires a finding that circumstances exist that the settlor, founder or grantor of the trust could not have known or anticipated. Also, the modification must conform as nearly as possible to the probable intention of the settlor, founder or grantor.

These standards can be difficult to apply in practice. For example, consider a charitable trust instrument with clear restrictions that “corpus” is to be preserved in perpetuity, and only “income” may be used for charitable purposes. The settlor of the trust passed away long before the current “total return” method of investing gained traction and was ultimately codified in UPMIFA. Under the total return approach, concepts such as corpus and income are irrelevant, and distributions or expenditures are usually made based on a percentage of asset value. It is generally accepted, as illustrated by the codification in UPMIFA, that the total return approach more adequately balances the competing interests of current distributions and long-term growth. However, can it be stated with confidence that the founders of the charitable trust could not have anticipated the evolution of total return investing? Further, does a modification of the trust to allow a total return approach “conform as nearly as possible” to the founder’s intent? To answer this question, one must decipher the departed founder’s intent. Should the question of intent be viewed narrowly (i.e., the founder intended to prohibit corpus invasions) or more broadly (i.e., the founder intended to benefit the expressed charitable purposes over the long term, and this is best accomplished with a total return approach). These are difficult questions to answer and turn on the unique circumstances of each case.

**V. CONVERSION FROM A CHARITABLE TRUST TO A NONPROFIT CORPORATION AND VICE VERSA**

Charities are most often formed as either nonprofit corporations or charitable trusts. It is generally agreed that a charitable trusts provides a more rigid structure than a nonprofit corporation. While this may be viewed as a detriment to a board of directors, to the founder this presents an opportunity to set forth values and purpose and ensure that core ideology will not be changed absent judicial intervention. Charitable trusts are generally governed

by the trust code of the state in which they are organized, as opposed to the business organizations code. Absent language in the trust allowing for modification, modification of a charitable trust will usually require approval of a court. In Texas (as discussed in detail above) any proceeding to amend a charitable trust requires notice to the OAG which serves as additional protection of the founder’s core ideology. While unusual, it is possible to “convert” a nonprofit corporation into a charitable trust to obtain the benefits of this choice of form. In Texas this is an actual conversion of a filing entity (a nonprofit corporation) to a non-filing entity (the charitable trust).

There are numerous differences between charitable trusts and nonprofit corporations. For a more in-depth review of this subject, please see Professor Terri Lynn Helge’s paper “Charitable Trusts v. Nonprofit Corporations” presented at the University of Texas School of Law 2011 Nonprofit Organizations Institute. Generally, charitable trusts are not subject to detailed statutory norms like those contained in the TBOC. Further, the corporate formalities of business organizations are not applicable to charitable trusts. Charitable trusts are not required to file their organizing document with the Secretary of State of Texas because they are not creatures of the state. In addition, if a nonprofit corporation wishes to change its domicile, it is free to do so. However, if a charitable trust wishes to move outside the State of Texas, the trustee must consult with a living settlor, make a proposal to the OAG, and file an action in the district court or statutory probate court in the county of the trust situs seeking such permission. *See* Tex. Prop. Code § 113.030.

In addition to these issues, the application of fiduciary law with respect to charitable trusts may differ from charitable corporations. While both trustees and corporate directors owe fiduciary duties as a matter of law, Texas law provides that directors of charitable corporations do not have the duties of a trustee of a trust. *See* Tex. Bus. Org. Code § 22.223.<sup>6</sup>

Nonprofit corporations are generally subject to UPMIFA. On the other hand, charitable trusts are governed by the Uniform Prudent Investor Act and the Uniform Principal and Income Act.

**A. Conversion of a Corporation to a Trust**

Section 10.101(a) of the TBOC provides that a domestic entity may convert into a different type of domestic entity or a non-code organization by adopting a plan of conversion. Section 1.002(56) defines “non-code organization” as an organization other than a “domestic entity” (which in turn is defined as an

<sup>6</sup> The predecessor to Section 22.223 was added to the Texas Non-Profit Corporation Act in 1993 primarily in order to confirm that trustees of charitable trusts are not subject to the stricter duties imposed on trustees of private funds.

organization formed under, or the internal affairs of which are governed by, the TBOC). As such, Section 10.101(a) seems to allow a nonprofit corporation (a domestic entity) to convert into a charitable trust (a non-code organization). An argument could be made that the phrase “non-code organization” nevertheless requires an “organization,” a term defined at Section 1.002(62) of the TBOC that does not include trusts (other than business trusts and REITs). While a charitable trust is not an “entity” in a formal sense, it is often treated as an entity under Texas law. The definition of “person” in the TBOC includes the phrase “or other organization” following a list that includes a trust, implying that a trust is, in fact, an “organization.” See TBOC § 1.002(69–b). Section 10.101(d) provides that a conversion may not take effect if prohibited by or inconsistent with the laws of the converted entity’s jurisdiction of formation. The Texas Trust Code does not prohibit such a conversion and, as discussed below, charitable trust documents often allow for a conversion from the trust form to the corporate form. As such, it is not inconsistent with trust law to see conversions, though it is unique to see a conversion from a corporate form to the trust form. The Texas Secretary of State’s office has informally reached the conclusion that a charitable trust is considered a non-code organization, allowing for a conversion to take place. The practitioner should consult with the office of the Texas Secretary of State and seek preclearance of any certificate of conversion before taking any steps to effectuate the filing of certificate of conversion.

**B. Conversion of a Trust to a Corporation**

A conversion of a charitable trust to a charitable corporation is much more common. Unless the trust instrument allows for such a conversion, the conversion may be effectuated only after approval of the court under Section 112.054. To gain approval the petitioner must be able to show the court the circumstances that have arisen unforeseen to the settlor that necessitate the need to convert to corporate form. See Tex. Prop. Code § 112.054. In the event the court agrees to allow the conversion (and the OAG waives intervention or agrees to same), the conversion is effectuated under Section 10.102 of the TBOC. Section 10.102(a) provides that a non-code organization may convert into a domestic entity by adopting a plan of conversion as provided by Section 10.102. Because the converted entity will be a filing entity (a nonprofit corporation), a certificate of formation must be included with the plan of conversion and be filed with the certificate of conversion. See TBOC § 10.155(a). Section 10.103 contains the required provisions for a plan of conversion. Section 10.154 contains the required provisions for the certificate of formation which must be filed as the

nonprofit corporation, a filing entity, is a party to the conversion.

**C. Effect of Conversion on Charitable Exemption**

Historically, the Internal Revenue Service has treated conversion from one entity type to another as the creation of a new entity necessitating a new application for exemption. See Rev. Rul. 67-390 1967-2 C.B. 179; see also *American New Covenant Church v. Commissioner*, 74 T.C. 293, 301 (T.C. 1980). The effect of this position was to require the organization, post-conversion, to file a new Form 1023, Application for Recognition of Exemption.

Revenue Ruling 67-390 considered four situations involving structural changes to exempt organizations:

- Case 1: An exempt trust was reorganized adopting a corporate form to carry out the same purposes for which the trust had been established with no change in operations.
- Case 2: An exempt unincorporated association was incorporated with a continuation of the same operations.
- Case 3: An exempt organization incorporated under state law was reincorporated by an Act of Congress to carry out the same purposes contained in its original charter.
- Case 4: An exempt organization incorporated under the laws of one state was reincorporated under the laws of another state with no change in its purpose or operations.

Revenue Ruling 67-390 held that in each of the four situations set forth above, a new legal entity had been created and was thus required to apply for exemption with a new Form 1023. This would further result in a final return for the taxpayer, and a new entity with a new Employer Identification Number. See, e.g., Rev. Rul. 67-390; Rev. Rul. 73-526; IRM 7.20.2.8; IRM 21.3.8.12.20.<sup>7</sup>

Two recent private letter rulings distinguish Rev. Rul. 67-390 and provide that if the converted entity continues to exist under applicable state law, the converted entity’s federal income tax exemption continues in effect. See Private Letter Ruling 201446025 (August 20, 2014); Private Letter Ruling 201426028 (April 1, 2014). In PLR 201446025, the IRS considered a nonprofit corporation formed in State 1 that planned to file “Articles of Domestication” with the corporation governing agency of State 2 and a Certificate of Conversion with the corporation

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<sup>7</sup> By way of clarification, in the event the organization is a private foundation, if effective control will continue in the successor organization, while the corporate taxpayer or trust taxpayer will cease to exist triggering a final return, there is no voluntary termination and the tax attributes of the original organization will carry over to the converted organization.

governing agency of State 1, with the effect of these filings being that the state of domicile would change from State 1 to State 2. The IRS ruled that this procedure would not create a new legal entity triggering the need to file an application for exemption, and, post-conversion, the entity could continue to rely on its previous determination of tax-exempt status. The IRS distinguished the scenarios in Rev. Ruls. 67-390 and 77-469, and *American New Covenant Church*, because in those instances a new legal entity was formed. In PLR 201446025, the IRS relied on the fact that the laws of State 1 and State 2 provided that the organization would maintain its original incorporation date and that it would be the same corporation with the same liabilities as prior to the domestication. Similarly, in PLR 201426028, the IRS considered whether a corporation originally created as a statutorily-enabled public nonprofit corporation converting to a nonprofit corporation formed under the state's business organizations code would result in a new legal entity. Again, the IRS ruled no new legal entity was created, relying on applicable state law, which provided that through the conversion process the organization would continue its existence uninterrupted.

Under Section 10.106(1) of the TBOC, "the converting entity continues to exist without interruption in the organizational form of the converted entity." As a result of this conversion statute, a conversion from a nonprofit corporation to a charitable trust or vice versa accomplished pursuant to statutory requirements of the TBOC should be analogous to the above-cited private letter rulings.<sup>8</sup>

The two private letter rulings addressed above both consider a corporation undergoing a conversion but maintaining the corporate form. The IRS could continue to rely on Rev. Rul. 67-390, and specifically Case 1 addressed therein, to take the position that a conversion that results in a change of form of entity (trust to corporation or corporation to trust) would result in a new legal entity. While the language in the conversion statute provides for uninterrupted existence, there are no private letter rulings specifically addressing this issue. The practitioner will want to weigh the risk in continuing on without a new Form 1023 against the time and expense of filing a new Form 1023 or filing a request for a private letter ruling.

## **VI. CONCLUSION**

Charitable trusts can serve useful purposes in the world of tax-exempt organizations, particularly as private foundations and endowments. However, they are unique in many ways and that uniqueness can create troublesome situations. Understanding the

nature of a charitable trust, how it operates, how it is modified (and with whose permission), and even how it can be converted provides the practitioner with useful tools to utilize and work with charitable trusts and their trustees.

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<sup>8</sup> A cautious practitioner will of course note that a private letter ruling cannot be relied upon and is directed only to the organization requesting it. See IRC § 6110(k)(3).