FIDUCIARY DUTIES 101
FOR CHARITY MANAGERSAND THEIR LEGAL COUNSEL

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I. OVERVIEW.

Lawyers who represent tax-exempt organizations must regularly meander through the statutory maze of excise taxes governing private foundations, donor-advised funds, public charities and certain other nonprofit entities. Many of these excise tax provisions in effect regulate fiduciary behavior. The same observation is true of certain basic requirements a charitable entity must meet so as to qualify for federal income tax exemption. For further discussion of these observations, see Johnny Rex Buckles, *The Federalization of Fiduciary Obedience Norms in Tax Laws Governing Charities: An Introduction to State Law Concepts and an Analysis of their Implications for Federal Tax Law*, 4 EST. PLAN. & COMMUNITY PROP. L. J. 197 (2012); Johnny Rex Buckles, *The Federalization of the Duty of Loyalty Governing Charity Fiduciaries under United States Tax Law,* 99 KY. L. J.645 (2011); Johnny Rex Buckles, *Fiduciary Assumptions Underlying the Federal Excise Taxation of Compensation Paid by Charities*, 45 REAL PROP. TR. & EST. L. J. 53 (2010).

Nevertheless, as significant as federal tax law is in regulating the conduct of charity fiduciaries, tax lawyers must also master the state law that governs the managers of their nonprofit clients. Understanding state law enables the tax lawyer (1) to advise clients how not to invite a lawsuit by the state attorney general or some other party with standing to sue; (2) to help clients understand principles of good governance (both for its own sake, and because of the importance that the Internal Revenue Service has placed on governance in recent years); (3) to better evaluate the advisability of efforts to reform state law and federal tax law; and (4) to reduce the likelihood of committing malpractice!

This Article discusses the general fiduciary duties imposed on members of the governing board of a Texas nonprofit corporation, and the standards used to determine whether a director has discharged his or her duties. This Article also discusses the fiduciary duties imposed on trustees of charitable trusts, and the standard of care applicable in special circumstances (including the management of investments). Basic issues of professional responsibility arising from a legal advisor's representation of nonprofit entities willalso be discussed.

This Article employs the following abbreviations: (1) "TBOC" means the Texas Business Organizations Code; (2) "TTC" means the Texas Trust Code (i.e., the sections of the Texas Property Code governing the law of trusts and trustees); and (3) "TUPMIFA" means the Texas version of the Uniform Prudent Management of Institutional Funds Act.

II. FIDUCIARY DUTIES GOVERNING DIRECTORS OF A NONPROFIT CORPORATION.

A. Duties of Directors and Standards for Discharging those Duties.

Traditionally, legal authorities state that directors of nonprofit corporations owe a duty of care and a duty of loyalty. As discussed below, some authorities further articulate a distinct "duty of obedience" that is owed by directors. Texas statutory law largely codifies the duties of care and loyalty with some degree of specificity. This section of the Article discusses the statutory explication of the duties of loyalty and care – and the standards by which discharge of such duties is judged – and authorities that bear upon whether, and (if so) in what sense, directors may owe a "duty of obedience" at some level.

1. In General.

A director must discharge his or her duties (1) in good faith, (2) with ordinary care, and (3) in a manner that the director reasonably believes to be in the best interest of the corporation. TEX. BUS. ORGS. CODE § 22.221(a). These standards apply to a director with respect to actions both on the governing board of the entity and on a committee. *See id.* Prong (2) essentially imposes the duty of care on directors, and prong (3) essentially imposes the duty of loyalty on directors. Prong (1)'s "good faith" may be conceptualized various ways; the author prefers to think of good faith as an element of both loyalty and care.

Prongs (2) and (3) are fairly straight-forward in principle, even if they articulate standards, compliance with which may be difficult to determine in some circumstances. "Ordinary care" means the care that an ordinarily prudent person in a similar position would exercise under similar circumstances. TEX. BUS. ORGS. CODE § 22.001(6). The requirement that a director act in a manner that the director reasonably believes to be in the corporation's best interest means that a director must put no other interest ahead of the corporation's interest, whether the competing interest is that of the director or that of a third person.

"Good faith" merits a bit more explanation. The official comment to section 8.30 of the Revised Model Nonprofit Corporation Act characterizes the requirement of good faith as a "precondition" to the discharge of duties as a director. It further states that a court "will look to the director's state of mind to see if it evidenced honesty and faithfulness to the director's duties and obligations." According to the American Law Institute's PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS (Tentative Draft no. 1, March 19, 2007) (hereinafter "PLNO"), the requirement of good faith is a component of both the duty of care and the duty of loyalty. *See id.* § 300, cmt. g(1). A failure to act in good faith includes conscious disregard of the charitable organization's best interests, "including intentionally abdicating the duty of care." *Id.* Good faith is also said to include the obligation of a director "to disclose to other board members nonconfidential material information that they do not already possess." *Id.* § 300, cmt. g(2).

2. Statutory Negation of Duties as Equivalent to those of a Trustee.

By statute, a director of a Texas nonprofit corporation is not considered to have the duties of a trustee of a trust, with respect to either the corporation or property held or administered by the corporation, including property subject to donor-imposed restrictions. TEX. BUS. ORGS. CODE § 22.223. This provision tracks the language of Section 8.30(e) of the Revised Model Nonprofit Corporation Act.

One should interpret this provision with care and caution. The statutory language does not appear to foreclose imposing on a nonprofit corporation – the entity itself (as distinguished from the entity's directors) – the duties of a trustee when the corporate entity serves as trustee of an express charitable trust.

3. Reliance on Other Persons.

a. Reliance on Others with Special Expertise or Knowledge: In General.

In discharging a duty or exercising a power, a member of the board of directors generally may rely on information, opinions, reports, or statements (including financial statements and other financial data) prepared or presented by (1) an officer or employee of the entity; (2) legal counsel; (3) a certified public accountant; (4) an investment banker; (5) a person who the director reasonably believes possesses professional expertise in the matter; or (6) a committee of the board of which the director is not a member. TEX. BUS. ORGS. CODE § 3.102(a). Such reliance is not always justified, however. A member of the board of directors may rely upon the foregoing information only if the director has done so in good faith and with ordinary care. TEX. BUS. ORGS. CODE § 3.102(a). Reliance is not in good faith if the director has knowledge of a matter that makes her reliance unwarranted. TEX. BUS. ORGS. CODE § 3.102(b).

b. Delegation of Investment Authority.

The board of directors of a corporation may, by contracting with an investment advisor, trust company, bank, or investment manager (an "advisor"), confer on the advisor the authority to purchase or otherwise acquire an investment on behalf of the corporation, and to sell, transfer, or otherwise dispose of an asset at a time and for a consideration that the advisor considers appropriate. TEX. BUS. ORGS. CODE § 22.224(a). Similarly, the board of directors may remove or replace the advisor, with or without cause, if the board considers that action appropriate or necessary. TEX. BUS. ORGS. CODE § 22.224(c).

The board of directors may also (1) confer on an advisor other powers regarding the corporation's investments as the board considers appropriate; and (2) authorize the advisor to hold title to property of the corporation, in the name of the advisor or a nominee, for the benefit of the corporation. TEX. BUS. ORGS. CODE § 22.224(b).

If the board acted in good faith and with ordinary care in selecting the advisor, directors are not liable for the advisor's actions (and failures to act). TEX. BUS. ORGS. CODE § 22.224(c).

4. Transactions Involving a Conflict of Interest.

a. In General.

Certain transactions entered into by a Texas nonprofit corporation are suspect because directors or related parties are financially interested in the transactions. These transactions are subject to special rules. The special rules apply to a contract or transaction between the following: (1) a nonprofit corporation and one or more of the nonprofit corporation's directors, officers, or members, or associates or affiliates of the foregoing; or (2) a nonprofit corporation and an entity or other organization in which one or more of the nonprofit corporation's directors, officers, or members, or associates or affiliates of the foregoing, is a managerial official or a member, or in which the same has a financial interest. TEX. BUS. ORGS. CODE § 22.230(a). This Article refers to any such contract or transaction as a "conflict-of-interest" transaction.

b. Validity of Conflict-of-Interest Transactions.

An otherwise valid, enforceable conflict-of-interest transaction is still valid and enforceable notwithstanding the presence of the financial interest or relationship described above if any one of the following three conditions is present:

> **1)** The material facts as to the relationship or interest, and as to the conflict-of-interest transaction, are disclosed to or known by the board of directors, a committee of the board, or the corporation's members, and the board, the committee, or the members in good faith and with ordinary care authorize the conflict-of-interest transaction by the affirmative vote of the majority of the disinterested directors, committee members or members, regardless of whether the disinterested directors, committee members or members constitute a quorum. TEX. BUS. ORGS. CODE § 22.230(b)(1)(A).
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> **2)** The material facts as to the relationship or interest, and as to the conflict-of-interest transaction, are disclosed to or known by the members entitled to vote on the authorization of the conflict-of-interest transaction, and the conflict-of-interest transaction is specifically approved in good faith and with ordinary care by a vote of the members. TEX. BUS. ORGS. CODE § 22.230(b)(1)(B).
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> **3)** The conflict-of-interest transaction is fair to the corporation when it is authorized, approved, or ratified by the board of directors, a committee of the board, or the corporation's members. TEX. BUS. ORGS. CODE § 22.230(b)(2).

Common or interested directors or members of a nonprofit corporation may be included in determining the presence of a quorum at a meeting of the board, a committee of the board, or members that authorize the conflict-of-interest transaction. TEX. BUS. ORGS. CODE § 22.230(c).

c. Effect on Directors' Liability.

If at least one of the three conditions set forth in II.A.4.b, above, is satisfied, the corporation will have no cause of action against any of the persons described above for breach of duty with respect to the making, authorization, or performance of the contract or transaction because the person had the relationship or interest described above or took any of certain actions authorized by the statute. TEX. BUS. ORGS. CODE § 22.230(e). Such actions include (1) participating in and, if the person is a director, member, or committee member, voting at a meeting of the board of directors, of members, or of a committee of the board (respectively) that authorizes the contract or transaction; and (2) signing, in the person's capacity as a director, member, or committee member, a written consent of the directors, members, or committee members (respectively) to authorize the contract or transaction. TEX. BUS. ORGS. CODE § 22.230(d).

d. Absolute Prohibition of Certain Loans.

Notwithstanding these general rules governing a conflict-of-interest transaction, a nonprofit corporation may not make a loan to a director. TEX. BUS. ORGS. CODE § 22.225(a). The directors who vote for or assent to the making of a loan to a director, and any officer who participates in making the loan, are jointly and severally liable to the corporation for the amount of the loan until it is repaid. TEX. BUS. ORGS. CODE § 22.225(b).

5. Distributions in Context of Insolvency or Liquidation.

a. General Liability for Distributions in Context of Insolvency or Liquidation.

In addition to any other liability imposed by law on the directors of a nonprofit corporation, the directors who vote for or assent to a distribution of assets (other than in payment of the corporation's debts), when the corporation is insolvent or when distribution would cause the corporation to be insolvent, or during the liquidation of the corporation, without the payment and discharge of, or making adequate provisions for, any known obligation of the corporation, are jointly and severally liable to the corporation for the value of the assets distributed, to the extent that the known obligation is not paid and discharged. TEX. BUS. ORGS. CODE § 22.226(a).

b. Exceptions.

1) Justifiable Reliance on Others.

A director is not liable if, in voting for or assenting to a distribution, the director relied in good faith and with ordinary care on information or an opinion, report, or statement in accordance with Section 3.102 of the TBOC, discussed *supra*. TEX. BUS. ORGS. CODE § 22.226(b)(1).

2) Good Faith and Ordinary Care Assessment.

A director is not liable if, in voting for or assenting to a distribution, the director, acting in good faith and with ordinary care, considered the assets of the corporation to be at least equal to their book value. TEX. BUS. ORGS. CODE § 22.226(b)(2).

3) Reliance on Third-Party Financial Information.

A director is not liable if, in voting for or assenting to a distribution, the director, in determining whether the corporation made adequate provision for the discharge of all of its obligations, relied in good faith and with ordinary care on financial statements of, or other information concerning, a person who was or became contractually obligated to discharge some or all of those liabilities or obligations. TEX. BUS. ORGS. CODE § 22.226(b)(3).

4) Verified Dissent.

A director who is present at a meeting of the board of directors at which an unlawful distribution of assets in the context of insolvency or liquidation occurs is presumed to have assented to the action unless (1) the director's dissent has been entered in the minutes of the meeting; (2) the director has filed a written dissent to the action with the person acting as the secretary of the meeting before the meeting is adjourned; or (3) the director has sent a written dissent by registered mail to the secretary of the corporation immediately after the meeting has been adjourned. TEX. BUS. ORGS. CODE § 22.227(a). Thus, a director can avoid liability by dissenting to the distribution and properly verifying that dissent. However, the right to dissent under this section does not apply to a director who voted in favor of the action. TEX. BUS. ORGS. CODE § 22.227(b).

5) Reliance on Legal Counsel.

A director is not liable for an unlawful distribution in the context of insolvency or liquidation if, in the exercise of ordinary care, the director acted in good faith and in reliance on the written opinion of an attorney for the corporation. TEX. BUS. ORGS. CODE § 22.228.

c. Right to Contribution.

A director against whom a claim is asserted in connection with an unlawful distribution in the context of insolvency or liquidation and who is held liable on the claim is entitled to contribution from persons who accepted or received the distribution knowing the distribution to have been made in violation of that section, in proportion to the amounts received by those persons. TEX. BUS. ORGS. CODE § 22.229.

6. Duties Associated with "Obedience" Norms.

a. Introduction to the (Disputed) Duty of Obedience.

Some courts and commentators state that a director owes a "duty of obedience" to the corporation. For example, in *Manhattan Eye, Ear and Throat Hosp. v. Spitzer*, 186 Misc. 2d 126, 152 (N.Y. Sup. Ct. 1999), the Supreme Court of New York County regarded as "axiomatic" the proposition that "the board of directors is charged with the duty to ensure that the mission of the charitable corporation is carried out." The court identified this duty as the "duty of obedience," and characterized it as requiring a director of a nonprofit corporation to "be faithful to the purposes and goals of the organization." *Id.*

In contrast, PLNO expressly declines to recognize a distinct "duty of obedience" and certain limitations on fiduciary behavior that the duty is understood to entail. *See* PLNO, § 300 cmt. g(3).

There is Texas case law specifically identifying the duty of obedience as such in the context of for-profit corporations, but the duty's substantive content is apparently limited to prohibiting acts contrary to charter provisions. *See, e.g., Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984).

Whether or not one recognizes a "duty of obedience" as such, an important task is to decide exactly what directors of a nonprofit corporation must "obey," under whatever duty (e.g., care or loyalty, exercised in good faith) they may fall. Parts II.A.6.b.1. & 2 briefly describe what the law generally requires corporate directors to obey. Parts II.A.6.c and following discuss a host of specific issues surrounding these general obedience norms.

b. What Must a Director Clearly "Obey" in General?

In general terms, it is clear that a director must cause her corporation to obey (1) the law; and (2) the corporation's governing instrument (e.g., its certificate of formation, or "charter").

1) Obedience to Law.

Nonprofit corporations, like other entities, are typically required to act in accordance with the law. *See, e.g.*, TEX. BUS. ORGS. CODE § 2.003(1)(A) (stating that a domestic entity may not engage in an "activity that is expressly unlawful or prohibited by a law of this state"). Fiduciaries who deliberately cause the entity to act unlawfully would presumably breach their statutory fiduciary duties. *Cf.* TEX. BUS. ORGS. CODE § 2.113(a) (stating that the statutory section specifying a domestic entity's powers "does not authorize ... a managerial official of a domestic entity to exercise a power in a manner inconsistent with a limitation on the purposes or powers of the entity contained in ... this code, or other law of this state"); *In re Walt Disney Co.,* 906 A.2d 27, 67 (Del. 2006) ("A failure to act in good faith may be shown ... where the fiduciary acts with the intent to violate applicable positive law....").

2) Obedience to Charter.

Directors of a nonprofit charitable corporation must not cause the entity to act contrary to its corporate purposes. *Cf.* TEX. BUS. ORGS. CODE § 2.113(a) (stating that the statutory section specifying a domestic entity's powers "does not authorize ... a managerial official of a domestic entity to exercise a power in a manner inconsistent with a limitation on the purposes or powers of the entity contained in its governing documents"). The Texas Attorney General may sue to enjoin any such action, and a corporation may sue a director who causes a corporation to act outside of its corporate purposes. *See* TEX. BUS. ORGS. CODE § 20.002(c)(2), (c)(3)(B). A positive duty imposed on directors to advance the charitable purposes of the corporations that they oversee has also been recognized. *See, e.g., Oberly v. Kirby,* 592 A.2d 445, 469 n. 17 (Del. 1991) (referring to "the special duty of the fiduciaries of a charitable corporation to protect and advance its charitable purpose"); *id.* at 472-73 (stating that the fiduciaries of a charitable corporation "have a special duty to advance its charitable goals").

c. Obedience and the Power to Amend Certificate of Formation.

TBOC section 3.051 authorizes a Texas nonprofit corporation to amend its certificate of formation. The question naturally arises, does the duty to obey charter terms preclude directors of a charitable corporation from amending its historic purposes stated in its certificate of formation? The better view is that the answer is "no." *See, e.g., City of Hughes Springs v. Hughes Springs Volunteer Ambulance Serv*., 223 S.W.3d 707, 710, 713-16 (Tex. App. 2007); *Attorney General v. Hahnemann Hosp.*, 397 Mass. 820, 834 (1986).

d. Obedience and the Power of Directors to Employ Pre-Amendment Donations to Further Amended Purposes or to Make Liquidating Distributions to Dissimilar Donees.

1) Introducing the Issue.

An issue that is not easily resolved is whether a charity may use assets held prior to a charter amendment—and assets received as substitutes or replacements for such pre-amendment assets—to further post-amendment purposes. A similar issue is whether a charity desiring to terminate its existence may, pursuant to a plan of dissolution, transfer its assets to a charity having purposes dissimilar to those expressed in its charter.[1] In either case, this Article will refer to a requirement that directors use assets to further the *historic charter purposes* of the charity in question as the "static charter fidelity norm."

2) Authorities Supporting Static Charter Fidelity Norm.

Some authorities have imposed the static charter fidelity norm on directors. *See, e.g.*, *In re Manhattan Eye, Ear & Throat Hospital v. Spitzer*, 186 Misc. 2d 126, 715 N.Y.S.2d 575 (N.Y. Supp. Ct. 1999); *Attorney General v. Hahnemann Hospital*, 494 N.E. 2d 1011 (Mass. 1986); *Queen of Angels Hospital v. Younger,* 136 Cal. Rptr. 36 (Cal. Ct. App. 1977); *Banner Health Sys. v. Long,* 663 N.W.2d 242 (S.D. 2003)

In Texas, the leading authority is is *Blocker v. State*, 718 S.W.2d 409 (Tex. Ct. App. – Houston [1st dist.] 1986), writ ref'd n.r.e. In *Blocker v. State,* the court held that the directors of a charitable corporation had breached their fiduciary duties by attempting to distribute corporate assets in dissolution to a private estate in which several directors had a beneficial interest. Although the holding itself is unremarkable, its rationale is potentially far-reaching. The language is sufficiently sweeping to reach contexts not involving dissolution of the corporation. The court held that property transferred to a charitable corporation is "subject to implicit charitable or educational limitations *defined by the donee's organizational purpose* and within the meaning of the statute, where no express limitation to the contrary is stated in the transfer." *Id.* at 415. According to the court, property that can be traced to such assets was likewise held by the charity "*subject to the limitations imposed on the corporation by the terms of its own articles of incorporation*." *Id.* (emphasis added); *see also id.* ("We hold that the real property and personalty were assets received and held by the corporation, whether from donation or purchase, subject to limitations permitting their use only for educational purposes, *by reference to the stated purposes set forth in the articles of incorporation*.") (emphasis in original). The court agreed with the state's argument that "by their very incorporation for purely charitable and benevolent purposes [charitable corporations] have made a contract with the State and with the beneficiaries named in the charters effectually constituting those in charge of the enterprise *trustees of an express trust, and their charters in their last analysis and in their legal effect become declarations of trust*." *Id.* at 416. Having reasoned that the assets of a charitable corporation are held in trust, the court then construed the statutory dissolution provision of then-existing law, which expressly required distributions in dissolution to transferees having purposes similar to those of the dissolving entity in the case of "[a]ssets received and held by the corporation subject to limitations permitting their use only for charitable, religious, eleemosynary, benevolent, educational or similar purposes." The court held that a non-profit corporation's acceptance of donations triggered this statutory provision under the theory that the terms of the donee's corporate charter rendered donations restricted charitable gifts. *See id.* at 415-16.

3) Authorities Rejecting Static Charter Fidelity Norm.

Not all authorities have imposed the static charter fidelity norm on directors. For example, PLNO provides that, if charter purposes are amended, general, unrestricted funds held by the charity may be used to advance post-amendment purposes. PLNO § 245 (preliminary draft). *See also Kans. E. Conference of the United Methodist Church, Inc. v. Bethany Medical Center, Inc.*, 969 P.2d 859 (Kan. 1998); *Dodge v. Trustees of Randolph-Macon Woman's College*, 661 S.E.2d 805 (Va. 2008).

In Texas, the most interesting case is *City of Hughes Springs v. Hughes Springs Volunteer Ambulance Serv.*, 223 S.W.3d 707, 710, 713-16 (Tex. App.—Texarkana 2007). In this case, a nonprofit corporation originally formed to operate an ambulance service was essentially foreclosed from performing its primary historical purpose by the actions of local government. Following these events, the nonprofit corporation amended its charter purposes so as "to provide various services to the community which relate to the health and safety of the citizens in the Hughes Springs area." A member of the nonprofit corporation

petitioned the court to dissolve and liquidate the entity. She relied on a provision of the Texas Nonprofit Corporation Act, TEX. REV. CIV. STAT. ANN. art. 1396-7.06 (Vernon 2003), which required a court to find, in relevant part, that "the corporation is unable to carry out its purposes." In relevant part, the court held that the amendments to the nonprofit's articles of incorporation were valid. *See Hughes Springs,* 223 S.W.3d 707, 714-15. In view of the propriety of the amended charter purposes, the member of the nonprofit corporation could not bring a petition to force liquidation of the entity under the statutory provision that conditioned such liquidation on a determination that "the corporation is unable to carry out its purposes." *See id.* at 716. The court reasoned that the statute did not apply, because the nonprofit "is able to carry out its purpose as amended." *See id.* The court further opined that "[t]he doctrine of *cy pres* does not prohibit the [corporation] from amending its purpose or require [it] to be dissolved." *Id.* at 716.

e. Obedience and Change in Mission.

There is little precedent directly and clearly articulating whether, and, if so, in what sense, directors of a nonprofit corporation have a duty to advance the corporation's mission. Two issues are relevant.

1) Obedience to Historic Mission?

One issue is whether the directors of a nonprofit charitable corporation (1) may, in the good faith exercise of prudence, change the corporation's mission and use its assets to further the new mission when the mission change requires no amendment to the corporate charter, or instead (2) must further the corporation's historic mission in the absence of judicial approval of a mission change. We may refer to a requirement that binds directors to a corporation's historic mission (absent judicially approved deviation) as the historic mission fidelity norm. A few authorities embracing the static charter fidelity norm also seem to support the historic mission fidelity norm. *See, e.g.*, *In re Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 593 (N.Y. Sup. Ct. 1999); *Queen of Angels,* 136 Cal. Rptr. 36, 40-41 (Cal. Ct. App. 1977). However, it is far from clear that these cases support recognition of the historic mission fidelity norm independently of the static charter fidelity norm. Cases that reject the static charter fidelity norm, *see. e.g.*, *City of Hughes Springs v. Hughes Springs Volunteer Ambulance Serv*., 223 S.W.3d 707, 710, 713-16 (Tex. App. 2007), likewise do not support adoption of the historic mission fidelity norm.

2) Obedience to Mission, as the Same May Be Modified over Time?

Let us assume that the Texas Supreme Court would hold that the directors of a nonprofit charitable corporation may, in the exercise of good faith and prudence, modify the corporation's mission and use all corporate assets to further the new mission. Another question is still relevant: Do the directors of a nonprofit corporation have an affirmative duty to advance the corporation's mission, as it may be amended from time to time? Although such a requirement finds some support among legal commentators, *see, e.g.,* Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity*, 76 FORDHAM L. REV. 893, 904-05 (2007), there is little binding legal authority on point. One could argue that requiring directors to govern so as to further the entity's mission is sensibly viewed as an

element of good faith, provided that "mission" is not defined statically. At a minimum, requiring directors to carry out a charity's mission, as the same may be amended from time to time, focuses managers' attention on mission and thereby promotes good governance.

f. Additional References on Obedience Norms.

For additional discussion of obedience norms, see Johnny Rex Buckles, *How Deep Are the Springs of Obedience Norms that Bind the Overseers of Charities?*; _____ CATH. UNIV. L. REV. ____ (2013) (forthcoming); Johnny Rex Buckles, *Nonprofit Directors and Obedience*, presented at the Governance of Nonprofit Organizations Course (sponsored by the State Bar of Texas) (August 24, 2012).

B. Special Situation: Investment and Management of Funds.

The general standards of care (and, to some degree, standards governing the duty of obedience) governing directors of a nonprofit, charitable corporation give way to the more specific standards applicable to the management and investment of an "institutional fund" subject to TUPMIFA. Section IV of this Article presents an overview of TUPMIFA.

C. Limiting Liability for Actions as Director.

1. Limiting Liability under the Certificate of Formation: In General.

The certificate of formation of a Texas nonprofit corporation may provide that a director is not liable to the organization or its members, or is liable thereto only to the extent provided by the certificate of formation, for monetary damages for an act or omission by the person in his or her capacity as a director. TEX. BUS. ORGS. CODE § 7.001(b).

2. Exceptions.

The general rule authorizing the limitation of a director's liability does not authorize the elimination or limitation of the liability of a director to the extent that he or she is found liable under applicable law for any of the following: (1) a breach of the duty of loyalty to the corporation or its members; (2) an act or omission not in good faith that constitutes a breach of duty to the corporation; (3) an act or omission not in good faith that involves intentional misconduct or a knowing violation of law; (4) a transaction from which the director received an improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the director's duties; or 5) an act or omission for which the liability of a director is expressly provided by an applicable statute. TEX. BUS. ORGS. CODE § 7.001(c).

III. FIDUCIARY DUTIES GOVERNING TRUSTEES OF A CHARITABLE TRUST.

A. Introduction to the Duties of a Trustee of a Trust.

1. In General.

A trustee must administer a trust in good faith and according to its terms. TEX. PROP. CODE § 113.051. Unless the trust instrument or the TTC states to the contrary, in administering the trust the trustee must perform all of the duties imposed on trustees by the common law. *Id.*

2. Applicability of the Texas Trust Code to Charitable Trusts: In General.

The terms and structure of the TTC make clear that the statute generally applies to charitable trusts. *See, e.g.,* TEX. PROP. CODE § 111.006 (stating that the TTC applies to all trusts created on or after January 1, 1984, and generally applies to all transactions occurring on or after January 1, 1984, relating to trusts created before January 1, 1984); TEX. PROP. CODE § 112.055 (imputing terms of trust governing "a trust that is a private foundation" as defined in Code section 509(a) so as to prohibit the trustee from acting in a way that triggers the private foundation excise taxes under the Code); TEX. PROP. CODE § 112.056 (permitting the written amendment of an instrument governing a private foundation to expressly include or exclude the provisions required by TEX. PROP. CODE § 112.055(a) if the settlor of the trust is living and competent and consents to the amendment); TEX. PROP. CODE § 113.0211 (permitting a trustee of certain types of charitable trust to manage investments under the prudent investor rule and to make certain adjustments between the principal and the income portions of a trust). Thus, specific fiduciary standards set forth in the TTC generally apply to the trustees of a charitable trust.

3. Applicability of the Texas Trust Code to Charitable Trusts: Effect of TUPMIFA.

a. Trusts to which TUPMIFA Does not Apply.

TUPMIFA generally defines an "institutional fund" (the management of which is governed by the standards of prudence set forth in TUPMIFA) as "a fund held by an institution exclusively for charitable purposes." TEX. PROP. CODE § 163.003(5). An "institution" includes a charitable trust and a charitable corporation. TEX. PROP. CODE § 163.003(4)(A) & (6). However, TUPMIFA excepts from the definition of "institutional fund" a "fund held for an institution by a trustee that is not an institution." TEX. PROP. CODE § 163.003(5)(B). Thus, charitable trusts of which individuals or for-profit corporations (such as bank and trust companies) are trustees are not subject to TUPMIFA, but a charitable trust of which another charity is trustee is governed by TUPMIFA. This construction of the statute is confirmed by the National Conference of Commissioners on Uniform State Laws' Prefatory Note and Comments to Section 2, Subsections 4, 5, and 6 accompanying their adoption of the Uniform Prudent Management of Institutional Funds Act. Thus, the TTC comprehensively governs charitable trusts that have individuals or for-profit corporate fiduciaries as trustees.

b. Trusts to which TUPMIFA Does Apply.

Section 163.011 of TUPMIFA states that the Texas Trust Code "does not apply to any institutional fund subject to this chapter." However, section 163.004(b) of TUPMIFA requires managers to comply with the general prudent investment standard of TUPMIFA "in addition to complying with the duty of loyalty imposed by law other than this chapter." Thus, TUPMIFA is best construed to supplant the provisions of the TTC that otherwise would govern standards of prudent investment and management of a "fund" held by a charitable trust of which a charitable entity is the trustee, but not the provisions of the TTC that do not pertain to prudent investment.

B. Duty of Loyalty.

1. In General.

A trustee must invest and manage trust assets solely in the interest of the beneficiaries. TEX. PROP. CODE § 117.007. The duty of loyalty "is general in its use and is fundamental." *Slay v. Burnett Trust*, 187 S.W. 2d 377, 387 (Tex. 1945). It prohibits a trustee "from using the advantage of his position to gain any benefit for himself at the expense of his cestui que trust and from placing himself in any position where his self interest will or may conflict with his obligations as trustee." *Id.* at 388. There are numerous provisions of the TTC, discussed in this Article, that apply this duty of loyalty in specific circumstances. These specific provisions do not, however, exhaust the contexts in which a trustee owes a duty of loyalty.

2. Impartiality.

If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing trust assets, taking into account any differing interests of the beneficiaries. TEX. PROP. CODE § 117.008.

3. Loan of Trust Funds.

Generally, a trustee may not lend trust funds to: (1) the trustee or an affiliate; (2) a director, officer, or employee of the trustee or an affiliate; (3) a relative of the trustee; or (4) the trustee's employer, employee, partner, or other business associate. TEX. PROP. CODE § 113.052(a). However, the following are permitted: (1) a loan by a trustee to a beneficiary of the trust if the loan is expressly authorized or directed by the instrument or transaction establishing the trust; and (2) a deposit by a corporate trustee with itself under TTC section 113.057. TEX. PROP. CODE § 113.052(b).

4. Purchase and Sales of Trust Assets.

A trustee may not directly or indirectly buy or sell trust property from or to: (1) the trustee or an affiliate; (2) a director, officer, or employee of the trustee or an affiliate; (3) a relative of the trustee; or (4) the trustee's employer, partner, or other business associate. The statute provides limited exceptions, primarily applicable to fiduciaries that are bank and trust companies. *See* TEX. PROP. CODE § 113.053.

5. Sale from One Trust to another Trust.

A trustee of one trust may not sell property to another trust of which it is also trustee unless the property is: (1) a bond, note, bill, or other obligation issued or fully guaranteed as to principal and interest by the United States; and (2) sold for its current market price. TEX. PROP. CODE § 113.054.

6. Purchase of Trustee's Securities or an Affiliate's Securities.

In general, a corporate trustee may not purchase for the trust the stock, bonds, obligations, or other securities of the trustee or an affiliate, and a noncorporate trustee may not purchase for the trust the stock, bonds, obligations, or other securities of a corporation with which the trustee is connected as director, owner, manager, or any other executive capacity. However, notwithstanding these rules, a trustee may: (1) generally retain stock already owned by the trust (unless the retention is imprudent); and (2) exercise stock rights or purchase fractional shares if permitted under TTC section 113.053. TEX. PROP. CODE § 113.055.

C. Duty of Prudent Investment.

Because TUPMIFA does not apply to a charitable trust managed by individual trustees or for-profit corporate trustees, standards of prudent investment governing those trustees appear in the TTC, not TUPMIFA. For such trustees, compliance with the TTC is imperative. <u>This portion of the Article focuses on the standards of prudent investment set forth in the TTC.</u>

1. The Prudent Investor Rule.

A trustee must invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee must exercise reasonable care, skill, and caution. TEX. PROP. CODE § 117.004(a). In general, a trustee may invest in any kind of property or type of investment consistent with these standards. TEX. PROP. CODE § 117.004(e).

2. Applicability of the Prudent Investor Rule.

Generally, a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule. TEX. PROP. CODE § 117.003(a). However, the prudent investor rule is a default rule, and as such may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust. TEX. PROP. CODE § 117.003(b).

3. Context for Applying the Prudent Investor Rule.

A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust. TEX. PROP. CODE § 117.004(b).

4. General Factors to Consider under the Prudent Investor Rule.

Among circumstances that a trustee must consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries: (1) general economic conditions; (2) the possible effect of inflation or deflation; (3) the expected tax consequences of investment decisions or strategies; (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property; (5) the expected total return from income and the appreciation of capital; (6) other resources of the beneficiaries; (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries. TEX. PROP. CODE § 117.004(c).

5. Duty to Diversify.

A trustee must diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying. TEX. PROP. CODE § 117.005.

6. Duty with Respect to Initial Trust Assets.

Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee must review the trust assets and make decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of the prudent investor rule. TEX. PROP. CODE § 117.006.

7. Trustee with Special Expertise.

A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise. TEX. PROP. CODE § 117.004(f).

8. Judging Compliance with the Prudent Investor Rule.

Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight. TEX. PROP. CODE § 117.010.

D. Duties with Respect to Delegation.

1. In General.

A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in (1) selecting an agent; (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation. TEX. PROP. CODE § 117.011(a).

2. Effect on Trustee's Liability.

A trustee who complies with the above requirements on delegation is not liable for the decisions or actions of the agent to whom the function was delegated, unless (1) the agent is an affiliate of the trustee; or (2) under the terms of the delegation, either (A) the trustee or a beneficiary of the trust is required to arbitrate disputes with the agent, or (B) the period for bringing an action by the trustee or a beneficiary of the trust with respect to an agent's actions is shortened from that which is applicable to trustees under state law. TEX. PROP. CODE § 117.011(c).

E. Duty to Obey Terms of Trust and Associated Exceptions.

As observed previously, under Texas law a trustee must administer a trust according to its terms. TEX. PROP. CODE § 113.051. Similarly, under the Restatement (Third) of Trusts, a trustee "has a duty to administer the trust, diligently and in good faith, in accordance with the terms of the trust and applicable law." RESTATEMENT (THIRD) OF TRUSTS § 76(1) (2003). The official comments to this Restatement rule refer to the duty as the "normal duty of a trustee to obey the terms of the trust." *Id.* § 76(1) at cmt. b(1). The law of charitable trusts permits deviation from trust terms only in limited circumstances.

1. The Doctrine of Cy Pres.

Under the traditional doctrine of cy pres, a court may direct charity fiduciaries to apply charitable trust funds to purposes similar to the original trust purposes when accomplishing the original purposes becomes impossible, impracticable, or illegal, as long as the transferor of the funds has manifested an intent to devote the funds to charitable purposes more general than the frustrated specific charitable purpose. *See* RESTATEMENT (SECOND) OF TRUSTS § 399 (1959); *cf.* RONALD CHESTER, GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 438 (3d ed. 2005) (stating that the doctrine applies when, in relevant part, furthering the charitable use intended by the donor "is or becomes impossible or impractical"); *id.* § 436 ("The courts that have applied judicial cy pres to a charitable trust have usually required that the settlor have exhibited a general or broad charitable intent in addition to the particular purpose served by that trust."); 6 AUSTIN W. SCOTT ET AL., 6 SCOTT AND ASCHER ON TRUSTS § 39.5.2 (2010) [hereinafter SCOTT AND ASCHER ON TRUSTS) (stating that a court may apply cy pres when it is "unlawful, impossible, impracticable, or wasteful" to carry out the settlor's particular charitable purposes).

Some sources articulate the doctrine as involving three prongs: (1) the settlor gratuitously transferred property in trust for a designated charitable purpose; (2) carrying out the designated purposes of the gift is, or becomes, impossible, impracticable, or illegal; and (3) the trustor manifested a general intention to devote the gifted property to charitable purposes. *See* 15 AM. JUR. 2D *Charities* § 149 (2002). *See generally* 6 SCOTT ET AL. § 39.5 (discussing the cy pres doctrine).

The Restatement (Third) of Trusts and the Uniform Trust Code alter the traditional common law doctrine of cy pres by adding wastefulness to the grounds for applying the doctrine and presuming that a donor possesses general charitable intent, but they otherwise follow the traditional doctrine of cy pres. *See* RESTATEMENT (THIRD) OF TRUSTS § 67 & cmt. b, *Reporter's Notes on § 67*, cmt. b (2003) (describing the modern rule as "displacing the traditional quest for a settlor's 'general charitable intent' when the trust"is silent); UNIF. TRUST CODE § 413 (2005).

2. The Doctrine of Equitable Deviation.

Closely related to the doctrine of cy pres is the doctrine of deviation (or "equitable deviation"). This latter doctrine empowers a court to direct a trustee of a charitable trust to deviate from the administrative terms of a trust if compliance with the original terms is impossible or illegal, or if compliance with the terms of trust would substantially impede the accomplishment of trust purposes on account of circumstances that the settlor did not foresee. *See* RESTATEMENT (THIRD) OF TRUSTS § 66(1) & cmt. c (2003) (expanding the doctrine to authorize deviation from terms that are not merely administrative); RESTATEMENT (SECOND) OF TRUSTS § 381 cmt. a (1959).

IV. OVERVIEW OF TUPMIFA.

A. Application of TUPMIFA.

As previously discussed, TUPMIFA generally applies to an "institution" that manages and invests "institutional funds" exclusively for charitable purposes. *See* TEX. PROP. CODE § 163.003(4). "Institutions" include nonprofit corporations, unincorporated associations, and other types of entities organized exclusively for charitable purposes, including private foundations described in Internal Revenue Code section 509(a). An "institutional fund" is generally defined as a "fund held by an institution exclusively for charitable purposes." TEX. PROP. CODE § 163.003(5). However, the term does not include "a fund held for an institution *by a trustee that is not an institution*." TEX. PROP. CODE § 163.003(5)(B) (emphasis added). Thus, as noted previously, although TUPMIFA potentially applies both to charitable corporations and to trusts for which a charitable organization serves as the trustee, it does not apply to charitable trusts with commercial or individual trustees. *See* TEX. PROP. CODE § 163.003(5)(B).

B. General Standard for Managing Institutional Funds.

A person responsible for managing and investing an institutional fund must "manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." TEX. PROP. CODE § 163.004(b). If not provided otherwise in a gift instrument, an institution must consider the following factors, if relevant, in managing and investing an institutional fund: (1) general economic conditions; (2) the possible effect of inflation or deflation; (3) the expected tax consequences, if any, of investment decisions or strategies; (4) the role that each investment or course of action plays within the overall investment portfolio of the fund; (5) the expected total return from income and the appreciation of investments; (6) other resources of the institution; (7) the needs of the institution and the fund to make distributions and to preserve capital; and (8) an asset's special relationship or special value, if any, to the charitable purposes of the institution. TEX. PROP. CODE § 163.004(e)(1).

C. Standards Governing Accumulations of, and Distributions from, an Endowment Fund.

Certain types of institutional funds – endowment funds – are subject to special rules governing accumulation and distribution. TUPMIFA defines an "endowment fund" 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." TEX. PROP. CODE § 163.003(2). However, an endowment fund "does not include assets that an institution designates as an endowment fund for its own use." *Id.*

1. General Standard of Prudence.

In general, and subject to "the intent of a donor expressed in the gift instrument" and special rules setting forth rebuttable presumptions of imprudence, TUPMIFA provides that "an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established." TEX. PROP. CODE § 163.005(a). TUPMIFA further states that, "in making a determination to appropriate or accumulate, the institution shall act in good faith, [and] with the care that an ordinarily prudent person in a like position would exercise under similar circumstances." *Id.*

2. Factors Bearing on Prudence.

TUPMIFA states that, in making a determination to appropriate or accumulate, the institution "shall consider, if relevant, the following factors": (1) the duration and preservation of the endowment fund; (2) the purposes of the institution and the endowment fund; (3) general economic conditions; (4) the possible effect of inflation or deflation; (5) the expected total return from income and the appreciation of investments; (6) other resources of the institution; and (7) the investment policy of the institution. TEX. PROP. CODE § 163.005(a).

3. Rebuttable Presumptions of Imprudence.

a. In General.

TUPMIFA sets forth a rebuttable presumption of imprudence that varies generally by endowment size, and that applies differently to extremely large university endowments. Generally, TUPMIFA classifies endowment funds into two categories—those with aggregate values of $1,000,000 or greater and those with aggregate values of less than $1,000,000.

- For endowment funds with a value of at least $1,000,000, an appropriation for expenditure of an amount greater than seven percent of the fair market value of an endowment fund—determined at least quarterly and averaged over a three year period—is presumed imprudent, but the presumption is rebuttable. *See* TEX. PROP. CODE § 163.005(d).

- For endowment funds valued at less than $1,000,000, TUPMIFA creates a rebuttable presumption of imprudence if more than five percent of the fair market value of the fund is appropriated for expenditure in one year. *See* TEX. PROP. CODE § 163.005(e). The rules regarding this presumption are the same as those for endowment funds valued at greater than $1,000,000, except for the smaller five percent threshold.

b. Special Rule for University Mega-Endowments.

Under TUPMIFA, the general seven percent rule does not apply to university system endowment funds valued at $450,000,000 or more. For these funds, the presumption of imprudence arises if an amount greater than nine percent of the fair market value of an endowment fund is appropriated for expenditure in one year. *See* TEX. PROP. CODE § 163.005(f).

D. Modifications of Donor Restrictions on Funds.

Donor restrictions on institutional funds raise obvious "obedience" questions. TUPMIFA sets forth specific rules for modifying donor restrictions.

1. Modification through Donor Consent.

Under TUPMIFA, an institution may release or modify a restriction if the donor consents in a tangible or electronic writing, provided that the fund continues to be used for a charitable purpose. *See* TEX. PROP. CODE § 163.007(a).

2. Modification through Court Action.

a. Modifying Restrictions on Fund Investing.

An institution may apply to a court for the modification of a restriction regarding the management or investment of an institutional fund if any of the following are true: (1) the restriction has become

impracticable or wasteful; (2) the restriction impairs the management or investment of the fund; or (3) a modification will further the purposes of the fund due to circumstances not anticipated by the donor. *See* TEX. PROP. CODE § 163.007(b). Requests for modification by a court require notification of the Office of the Texas Attorney General in accordance with Chapter 123 of the Texas Property Code. *See id.*; TEX. PROP. CODE § 123.003.

b. Modifying Restrictions on Fund Uses and Purposes.

A court may also modify the purpose of a fund or a restriction on the use of a fund if the purpose or restriction has become unlawful, impracticable, impossible to achieve, or wasteful. *See* TEX. PROP. CODE § 163.007(c). Any such modification must be consistent with the charitable purposes expressed in the gift instrument. *See id.* Requests for modification by a court require notification of the Office of the Texas Attorney General in accordance with Chapter 123 of the Texas Property Code. *See id.*; TEX. PROP. CODE § 123.003.

3. Special Rule for Small, Long-Held Funds.

An institution may release or modify a restriction without donor or court consent if the restriction is unlawful, impracticable, impossible to achieve, or wasteful, and all of the following are satisfied: (1) the institutional fund in question has a total value of less than $25,000; (2) more than twenty years have passed since the establishment of the fund; and (3) the institution uses the property in a manner that is consistent with the charitable purposes expressed in the gift instrument. *See* TEX. PROP. CODE § 163.007(d). An institution wishing to modify or release a restriction by its own authority may not act until sixty days after the attorney general receives notice of the intended action accompanied by a copy of the gift instrument and a statement of the facts. *See id.*

E. Additional Analysis of UPMIFA.

For a more advanced discussion of the issues raised by UPMIFA, see Johnny Rex Buckles, *Probing UPMIFA: The Mysteries of the Uniform Act in Light of Federal Tax and State Charity Laws and Concepts*, 46 REAL PROP. TR. & EST. L. J. 281 (2011).

V. PROFESSIONAL RESPONSIBILITY ISSUES.

A. First Principles: Identifying the Client.

1. Organization as Client.

Under the Texas Disciplinary Rules of Professional Conduct ("TDRPC"), an attorney "employed or retained by an organization represents the entity." TDRPC § 1.12(a). The organization is distinguishable from its "constituents," *see, e.g., id.,* which include an organization's "directors, officers, employees, members, shareholders." *See, e.g.,* TDRP §11.12(e). *See also* TDRPC § 1.12 cmt. 1 ("A lawyer

employed or retained to represent an organization represents the organization as distinct from its directors, officers, employees, members, shareholders or other constituents."); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §96 cmt. b (2000) ("A lawyer who has been employed or retained to represent an organization as a client owes professional duties of loyalty and competence to the organization. By representing the organization, a lawyer does not thereby also form a client-lawyer relationship with all or any individuals employed by it or who direct its operations or who have an ownership or other beneficial interest in it ….").

2. Directors and Trustees as Representatives of Client.

Of course, charities must act through charity fiduciaries (e.g., directors, trustees and officers). *See* TDRPC § 1.12 cmt. 1 ("Unlike individual clients who can speak and decide finally and authoritatively for themselves, an organization can speak and decide only through its agents or constituents such as its officers or employees."). Consequently, "the lawyer-client relationship must be maintained through a constituent who acts as an intermediary between the organizational client and the lawyer." *Id.* Directors, trustees and officers, acting in a representative capacity, are thus those through whom the lawyer typically advises the organizational client.

B. Issues Arising from the Dual Capacity of Charity Fiduciaries: In General.

When an attorney is contacted by a charity fiduciary (e.g., a director or officer), the lawyer must be sensitive to the multiple capacities in which the fiduciary can act. A lawyer who has long represented a charity may be asked a legal question by a member of the charity's board of directors, for example, that raises issues not only for the charity, but also for the fiduciary personally.

1. Advice to Fiduciaries as Advice to Client.

When a director, trustee or officer of the client seeks legal counsel as to how it should act on behalf of the client, the representative is normally seeking legal advice on behalf of the client. When the attorney advises the representative in such circumstances, he or she is advising the organizational client. In many circumstances, when a director, trustee or officer seeks legal advice as to whether a proposed action is consistent with her fiduciary duties, often the legal advice is properly viewed as having been given to the organization. This conclusion follows from the premises that (1) an entity must act through its agents, including the fiduciaries who manage it; and (2) to properly discharge one's fiduciary duties is to act on behalf of the entity in the manner required by law.

Whether a charity fiduciary seeks legal advice primarily for herself, or instead for her charity, may not be clear, however. *The practical implication is obvious: When in doubt, spell it out!* Consider the following:

> [A] lawyer's failure to clarify whom the lawyer represents in circumstances calling for such a

> result might lead a lawyer to have entered into client-lawyer representations not intended by the lawyer. Hence, the lawyer must clarify whom the lawyer intends to represent when the lawyer knows or reasonably should know that, contrary to the lawyer's own intention, a person, individually, or agents of an entity, on behalf of the entity, reasonably rely on the lawyer to provide legal services to that person or entity …. Such clarification may be required, for example, with respect to an officer of an entity client such as a corporation…. An implication that such a relationship exists is more likely to be found when the lawyer performs personal legal services for an individual as well or where the organization is small and characterized by extensive common ownership and management. But the lawyer does not enter into a client-lawyer relationship with a person associated with an organizational client solely because the person communicates with the lawyer on matters relevant to the organization that are also relevant to the personal situation of the person. In all events, the question is one of fact based on the reasonable and apparent expectations of the person or entity whose status as client is in question.

RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 14 cmt. f. (2000).

2. Joint Representation.

Subject to TDRPC § 1.6, an attorney may represent both an organizational client and its constituents (such as a director). *See* TDRPC § 1.12 cmt. 5.

3. Adverse Interests.

An organizational client's interest may be or become adverse to the interests of a constituent. Under the TDRPC, a lawyer must explain to an organizational client's constituents, such as directors and officers, "the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing or when explanation appears reasonably necessary to avoid misunderstanding on their part." TDRPC §1.12(e). Commentary to the TDRPC provides the following expanded guidance in the case of adverse interests:

> [T]he lawyers should advise any constituent, whose interest the lawyer finds adverse to that of the organization of the conflict or potential conflict of interest, that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation. Care should be taken to assure that the individual understands that, when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for that constituent individual, and that discussions between the lawyer for the organization and the individual may not be privileged insofar as that individual is concerned. Whether such a warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case.

TDRPC §1.12 cmt. 4.

C. When and How Lawyer Must Take Remedial Action on Behalf of Organizational Client.

1. Text and Illustration of Rule Requiring Remedial Action.

Under the TDRPC, a lawyer representing an organization must take reasonable remedial actions whenever the lawyer learns or knows that: (1) an officer, employee, or other person associated with the organization has committed or intends to commit a violation of a legal obligation to the organization or a violation of law which reasonably might be imputed to the organization; (2) the violation is likely to result in substantial injury to the organization; and (3) the violation is related to a matter within the scope of the lawyers representation of the organization. TDRPC § 1.12 (b).

A director's obvious, contemplated breach of the duty of loyalty would trigger this rule. Consider the following illustration set forth in the Restatement (Third) of the Law Governing Lawyers:

> Charity promotes medical research through tax-deductible contributions made to it. President as chief executive officer of Charity retained Lawyer to represent Charity as outside general counsel and has extensively communicated in confidence with Lawyer on a variety of matters concerning Charity. President asks Lawyer to draft documents by which Charity would make a gift of a new luxury automobile to a social friend of President. In that and all other work, Lawyer represents only Charity and not President as a client. Lawyer concludes that such a gift would cause financial harm to Charity in violation of President's legal duties to it. Lawyer may not draft the documents. If unable to dissuade President from effecting the gift, Lawyer must take action to protect the interests of Charity (see Subsection (2) & Comment *f*). Lawyer may, for example, communicate with members of Charity's board of directors in endeavoring to prevent the gift from being effectuated.

RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §96 cmt. e, *Illus*. 1 (2000).

However, a lawyer should not substitute his own judgment for that of directors on prudential/business matters. Comment 6 to TDRPC section 1.12 cautions that an organizational client's constituents' decisions "ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful." Decisions about policy and operations, even risky ones, "are not as such in the lawyer's province." TDRPC §1.12 cmt. 6. But remedial measures must be taken "when the lawyer knows, in regard to a matter within the scope of the lawyer's responsibility, that the organization is likely to be substantially injured by the action of a constituent that is in violation of law or in violation of a legal obligation to the organization." *Id*.

2. Procedures to Remediate.

The TDRPC set forth the following pathway for remediating the actions of constituents of an

organizational client:

> Except where prior disclosure to persons outside the organization is required by law or other Rules, a lawyer shall first attempt to resolve a violation by taking measures within the organization. In determining the internal procedures, actions or measures that are reasonably necessary in order to comply with paragraphs (a) and (b), a lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyers representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters, and any other relevant considerations. Such procedures, actions and measures may include, but are not limited to, the following: (1) asking reconsideration of the matter; (2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization; and
> (3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law.

TDRPC §1.12(c).

D. Lawyer's Service on Client's Board of Directors.

There is no per se prohibition against service by legal counsel on a client's board of directors in Texas. However, the practice does create the potential for conflicts. Note that an attorney owes fiduciary duties to the client by virtue of legal representation, and that the attorney also owes fiduciary duties as a director. A comment to the TDRPC states as follows:

> A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director.

TDRPC § 1.06 cmt. 16.

E. Lawyer's Competence in Advising on Fiduciary Duties.

Many transactions about which an attorney's client may seek legal advice raise not only state law fiduciary duty issues, but also issues under federal tax laws governing charitable nonprofits and their managers. For example, Code sections 4941 and 4958 impose excise taxes on various types of conflict-of-interest

transactions between certain types of charities and various types of charity insiders. Indeed, one may conceptualize many provisions of the Internal Revenue Code as federalizations of fiduciary duties. A lawyer advising charity fiduciaries of their duties to the client must be well versed in these tax laws in order to render complete advice. In this connection, observe that TDRPC 1.01(a) generally imposes a requirement that a lawyer represent a client only in matters within the lawyer's competence. According to the comments,

> A lawyer generally should not accept or continue employment in any area of the law in which the lawyer is not and will not be prepared to render competent legal services. Competence is defined in Terminology as possession of the legal knowledge, skill, and training reasonably necessary for the representation. Competent representation contemplates appropriate application by the lawyer of that legal knowledge, skill and training, reasonable thoroughness in the study and analysis of the law and facts, and reasonable attentiveness to the responsibilities owed to the client.

TDRPC § 1.01 cmt. 1.

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[1] Some state statutes require dissolving charities to distribute assets to organizations having charitable purposes similar to those of the dissolving entity. *See, e.g.*, N.Y. NOT-FOR-PROFIT CORP. LAW § 1002-a(c)(1) (2011). Other statutes provide simply that the corporation must distribute its assets to other tax-exempt charities or governmental bodies (as Texas law now provides). *See, e.g.*, TEX. BUS. ORGS. CODE § 22.304(a)(2). If, as in Texas, the state statute does not literally require a dissolving entity to distribute assets only to a charitable transferee with specific purposes similar to those of the transferor, a court may be asked to decide whether to employ common law trust concepts to compel such a result.