Restricted Charitable Donations and the "Cy Pres" Doctrine

Mehmet Bac*

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Abstract

Courts apply the "cy pres" doctrine to best approximate deceased donor restrictions when these become illegal or impossible to carry out. I show, in a model of strategic donations, that a commitment to further protect deceased donor restrictions attracts more funds today at the price of inefficient allocation of funds tomorrow. The analysis identifies the benefits and costs of relaxing the doctrine, suggesting that a more flexible application by properly balancing its impact on present donations and future efficiency concerns, if feasible, would better serve to promote intergenerational social welfare.

Key Words: Donations, Charity, Efficiency, Dynamic Game.

*Faculty of Arts and Sciences, Sabanci University, Orhanli, Tuzla 81474, Istanbul, Turkey; E-mail: bac@sabanciuniv.edu

"If a man will not give except on the terms of having his commands obeyed for ever, then, say I, let him keep his money, and let it perish with him."

Arthur Hobhouse

1 Introduction

In the US and most European countries, the law of charitable trusts stipulates strict adherence to donors' stated charitable restrictions, with a minor exception. The exception, embodied in the *"cy pres"* doctrine, allows for a deviation from stated donor restrictions only if quite strong justifications are supplied for reallocating funds to alternative charitable purposes.[1] It must be shown that the donor's intentions no longer qualify charitable, and next, that donor's intentions were "generally" charitable. When these requirements are met, the court modifies the charitable purpose as near to the donor's original intentions as possible. Most observers and scholars rightly view the cy pres doctrine as overprivileging donors. According to Brody (1998), the doctrine as practiced generates a "market failure, the 'separation of supply from demand'—if by 'demand' we mean the beneficiaries' demand rather than the donor's." Fisch (1974) proposes that American courts adopt a greater degree of flexibility to provide better uses for the millions of dollars locked in many donor-restricted funds.[2]

[1] *Black's Law Dictionary* (6th edition (1990)) defines the cy pres doctrine as "a rule for the construction of instruments in equity, by which the intention of the party is carried out as near as may be, when it would be impossible or illegal to give it literal effect." See Brody (1997) for a brief historical account of the doctrine in England and United States. An example of a restricted charitable gift would be a donation of X dollars toa college, with the instruction that only the income from the principal X be used by the college, solely for the purchase of books and journals in a specific field.

[2] The doctrine is also applied to modifications in a charitable corporation's purposes and form. In the case of nonprofit hospitals bound by donor restrictions, the cy pres doctrine may prevent conversion to the for-profit form. See Hansmann (1996) and Singer (1997) on the hospital conversion issue, Rudko (1998) for an interesting account of cy pres doctrine in the context of Fourteenth

Donors may have several motives in imposing long-term charitable purpose restrictions, such as extending their influence over the future or building a safeguard against trustees' potential opportunistic deviations that may compromise charitable intent of their donations. Another motive which Loftin (1999) emphasizes could be outcome orientation in giving (as opposed to attributing value to the act of giving itself). To be sure, donors are not indifferent about how their donations will be used, but neither is the general public. Why does the law insist on such a close approximation, if any, of deceased donors' restrictions when enforcing these restrictions is clearly socially inefficient? Though each one of the answers listed below may contain some element of truth, none, I argue, constitutes a satisfactory explanation for leaving the charitable dollar under the dead hand control.

First, acceptance of a restricted donation can be viewed as a contractual agreement between the donor and the trust, the latter being an agency managing the former's property, therefore the restriction must be enforced as long as it remains legal and is not harmful to the public.[3] But the restriction is intended in the first place to serve a "nonsignatory", i.e., the beneficiaries.[4] To forbid deviations that would obviously better serve the beneficiaries seems puzzling. Second, the cy pres doctrine may act as a safeguard against trustees' opportunistic attempts to divert donor funds to serve their narrow private interests. Nor is this a plausible economic explanation for a strict application of the doctrine because opportunistic board behavior should be a concern for both restricted and unrestricted funds; there seems no obvious reason for subjecting management of restricted funds to additional doctrinal measures.[5] Third, as Atkinson (1993) points out, there are difficulties in drafting a clear definition of a socially efficient charitable policy. Lacking a clear

Ammendment, and Atkinson (1993) for a general evaluation. Atkinson proposes eliminating legal enforcement to give full discretion to the board of trustees in determining policies.

[3]See Johnson and Taylor (1989) who argue that it would be inherently wrong to disregard donor restrictions for this would break up a commitment and violate donors' property rights.

[4]This, in fact, is the reason why the law eliminates donors' direct control over their gifts following the donation.

[5]Brody (1998) pp. 1415-1427 discusses the problems in monitoring and regulating trustee behavior.

definition to guide the courts, he argues, efficiency-based deviations from donor restrictions can hardly be operationalized. However, a reasonably clear and general definition of, at least, what constitutes obviously inefficient, outmoded uses of donor funds should not be beyond the reach of law makers. The effort is worthwhile given the potential benefits involved. Finally, the warning that too much state intervention would jeopardize independence of the charity sector does not on its own seem to be a viable defense of a strictly applied cy pres doctrine. Correction of market failures is a well-known, important economic role of the state.

The purpose of this paper is to demonstrate that protection of donor-imposed restrictions on future charitable policies has at least two important, opposing effects. I present a model of strategic donations where a donor derives utility from imposing her own preferences regarding future charitable policies. The donor's strategic choice is the level of donation, which she decides on the basis of given legislation governing protection of donor restrictions. The more strictly these restrictions are or expected to be protected, the larger the donor is willing to donate today. Given this induced donor behavior, I show that law makers should balance a delicate trade-off in a reform of the cy pres doctrine: A strict commitment to protect donor restrictions induces generous donations but runs a large risk of ex-post inefficient use of the funds, while too flexible a protection policy would shy donor funds away, though what is donated would ex-post be allocated quite efficiently. Viewed from this perspective, the "cy pres" doctrine as applied today by the courts overprotects donor restrictions at the heavy cost of foregone social welfare. Relaxing these protections will possibly have an undesirable effect on the amount of donations, which, at least for a marginal relaxation of protections, is likely to be more than offset by an improved efficiency in the allocation of donor funds. The next section develops the game-theoretic model. Section 3 contains the analysis and a discussion of the impact of allowing for strategic purpose setting for donations and for trustees to deviate from socially optimal policies. Section 4 provides concluding remarks.

2 A Model of Strategic Donation

Consider a donor who derives utility mainly from two activities, providing a perpetual gift to a charitable trust and alternative uses of his wealth, called "personal consumption". The law allows the donor to impose restrictions on potential uses of the gift and specifies how strictly the restrictions will be protected in the future. The size of the gift, determined by the donor, is denoted G. Therefore, $C = W - G$ is left for "personal consumption," where W is the donor's wealth. The possibility of unrestricted charitable giving is excluded to keep the analysis simple; my qualitative result goes unaffected as long as changes in restricted charitable giving are not completely crowded out by unrestricted charitable giving.

A particular charitable use of deceased donor funds is called "a policy" and denoted q. There is a socially optimal policy in the future with funds G, unknown at the time the gift is made; this optimal policy is determined by a random variable "the state", denoted ω. The state ω characterizes all the relevant facts for the socially optimal use of donor funds. Let there be $2n+1$ possible states and denote the set of possible states by $\Omega = \{-n, \cdots -1, 0, 1, \cdots n\}$, where n can be arbitrarily large. The probability of state ω is $p(\omega)$. To economize on notation, I let Ω represent also the set of possible policies, and adopt the convention that the socially optimal policy in state ω is ω, i.e., $q^*(\omega) = \omega$. Thus, a policy can be defined as a function $q : \Omega \to \Omega$, of the form "in state $x \in \Omega$ use funds in policy $y \in \Omega$."[6] Since $q^*(\omega) = \omega$, it follows that $p(q)$ also denotes the probability that policy $q = q^*(\omega)$ is socially optimal.

The donor's preferences are "single-peaked" at the (most preferred) policy $q = 0$. Let the set of states and policies, Ω, be ordered so that the donor's second best choice is $q = 1$ or $q = -1$, followed by $q = 2$ or $q = -2$, and so on.[7] The

[6]Thus, while the state may comprise circumstantial information regarding whether a new epidemics is threatening the population, a list of problems in higher education, public health, the level of poverty, and so forth, the policy describes how funds will be used in each state.

[7]No assumption is needed regarding the preferences over pairs of policies $q = l$ and $q = -l$ that are "equidistant" from the donor's most preferred policy $q = 0$.

donor's preferences are defined over the set of contributions and personal consumption levels, and the space of lotteries over charitable policies. These preferences are represented by the (Bernouilli) utility function $U(C, G, q)$, assumed strictly quasi-concave with respect to its first two arguments.[8] For any given allocation of wealth, the "further away" the chosen policy from the donor's most preferred policy $q = 0$, the lower are the donor's absolute and marginal utilities from contributing funds. This assumption is stated as

$$U(C, G, |q_1|) > U(C, G, |q_2|)^9$$

and

$$\frac{\partial U(.,.;|q_1|)}{\partial G} > \frac{\partial U(.,.;|q_2|)}{\partial G} \quad \text{if and only if} \quad |q_1| < |q_2|.$$

The first inequality above is basic. The second inequality is quite natural and plausible; it states that the donor's utility from giving an additional (marginal) dollar is higher if a more preferred policy will be chosen with probability one.

The contributed funds G will be managed by the trustees whose preferences are commonly known to differ from the donor's: the trustees will ex-post prefer to use the funds in the socially optimal policy, but they will be bound by law to approximately follow donor restrictions. The decision as to how closely the trustees will be permitted to approximate donor intentions is left to law makers.[10] The criterion they use in this decision is maximization of a social welfare function (stated explicitly in the sequel) that is increasing in the funds G the donor makes available, *and* depends on expected policies that will be adopted. I assume two periods, the present and the future, and zero discounting for simplicity. The sequence of events,

[8] For simplicity, I assume that the donor's preferences are state-independent, which eliminates the possibility of state-contingent restrictions on the gift. The qualitative arguments in this paper would not change if state-dependent preferences are allowed.

[9] $|x|$ denotes the absolute value of the integer x.

[10] The permission of the court must be obtained, otherwise the Attorney General gains standing to sue the trustees and enforce the terms of the restriction. The process of obtaining court permission, when the modification is legal so that the permission will be accorded, is implicit in the following analysis.

outlined below, generates an extensive form game with three players, the donor, the trustees and the law maker.

- *(The beginning)* The law maker determines the law governing how strictly donor restrictions will be protected. This is captured by letting the law maker choose a number $s < n$, $s \in \Omega$, forbidding deviations to the policies $q \in N(s) \equiv \{-n, \cdots, -s-1\} \cup \{s+1, \cdots, n\}$, thus restricting policies to the set $S(s) = \{-s, \cdots, 0, \cdots, s\}$. I refer to this protection rule as the $|s|$-*pres* doctrine.[11]

- (*Present*) The donor determines the donation amount G and restriction to a policy, and dies.

- (*Future*) The state ω is realized, hence also the socially optimal policy $q^*(\omega) = \omega$. The trustees determine the actual policy $q \in S(s)$ according to the $|s|$-pres doctrine.

Formally, the strategies in this game are defined as follows. The law maker's strategy is to pick $s \in \{-n, \cdots, 0, \cdots, n\}$, a level of protection for donor restrictions "$|s|$-pres," committing to enforce donor restrictions (approximately) within the set $S(s) = \{-s, \cdots, 0, \cdots, s\}$ of policies. Given this, the donor's strategy is to impose the policy restriction $q = 0$ and determine a corresponding contribution. The contribution strategy is a function $G : S(s) \to R^+$, mapping the protection rule to the set of donations. Finally, the trustees' strategy is to pick $q \in S(s)$, a policy from the admissible set. The appropriate solution concept for this game, adopted below, is Subgame Perfect equilibrium.

Three remarks are in order, followed by the analysis of the game.

1. The donor's preferences as defined above always induce the singleton policy restriction $q = 0$. It is possible to generate more flexible donor restrictions

[11] The French word "pres" means near, close. The cy pres doctrine has its origins in Norman French, where *"cy pres comme possible"* means "as near as possible". Thus, $|s|$-pres would mean protection of donor restrictions up to a distance $|s|$ from the donor's restriction.

by assuming that the donor derives utility also from adoption of socially optimal policies in the future, besides enjoying to impose her own preferred policies. Then the donor may find it optimal to broaden the set of options she makes available to the trustees. Incorporating this aspect, however, would complicate the analysis without changing the qualitative results.

2. The assumption that trustees' objective is to pick the socially optimal policy (under the constraint imposed by legal protection of donor restrictions) is innocuous, given the purpose of the analysis. The trade-off between the level of donations and ex-post inefficiency of charitable policies remains effective even if trustees are allowed to pursue alternative objectives.

3. Conceiving the donor as a "dead hand" that posthumously derives utility from the adopted policy would be a misinterpretation. The living donor forms expectations about what set of policies may be implemented with her funds in the future and derives utility now, from the power of influencing future policies.

3 The Analysis

The trustees' optimal decision at the final stage of the game is straightforward: Given s and the realized state ω, set

$$q(\omega) = \begin{cases} q^*(\omega) & \text{if} \quad \omega \in S(s)\,; \\ \tilde{q}(s) & \text{if} \quad \omega \in N(s)\,, \end{cases} \tag{1}$$

where $\tilde{q}(s) \in S(s)$ is the "second best" policy to which the trustees are legally permitted to deviate when $\omega \notin S(s)$ so that the optimal policy is not implementable (it lies in the complementary set $N(s)$, to which the trustees are not allowed to deviate). Given the trustees' optimal behavior specified above, the donor's problem can be stated as follows: Impose the restriction $q = 0$ and determine the donation

G that solves the problem

$$max_{C,G} EU(C, G, q(\omega)) \quad \text{subject to} \quad C + G = W \tag{2}$$

where "E" denotes the expectation operator and $q(\omega)$ is the trustees' strategy as given in (1).

As a benchmark, consider the case in which $s = n$, hence $S(n) = \Omega$, the law maker provides no protection to donor restrictions. The trustees now enjoy complete freedom and will always be able to implement the socially optimal policy $q^*(\omega)$. The donor will foresee this and determine his optimal gift $G(n)$ to satisfy the first order condition

$$\sum_{\omega=-n}^{n} p(\omega)[\frac{\partial U(C(n), G(n); q^*(\omega))}{\partial G} - \frac{\partial U(C(n), G(n); q^*(\omega))}{\partial C}] = 0. \tag{3}$$

Assume that the solution is interior, $0 < G(n) < W$.[12]

Consider now the case of partial, "$|s|$-pres" protection of donor restrictions, so let $s < n$ (full protection would correspond to $s = 0$). The probability that the trustees will not be able to implement the optimal policy due to the protection is $\sum_{\omega=-n}^{-s-1} p(\omega) + \sum_{\omega=s+1}^{n} p(\omega)$; they will instead implement the policy $\tilde{q}(s)$, the best available from the set $S(s)$. Given this, the first-order condition determining the donor's optimal gift choice is modified as below:

$$\sum_{\omega \in S(s)} p(\omega)[\frac{\partial U(C(s), G(s); q^*(\omega))}{\partial G} - \frac{\partial U(C(s), G(s); q^*(\omega))}{\partial C}]$$

$$+ \sum_{\omega \in N(s)} p(\omega)[\frac{\partial U(C(s), G(s); \tilde{q}(s))}{\partial G} - \frac{\partial U(C(s), G(s); \tilde{q}(s))}{\partial C}] = 0. \tag{4}$$

Condition (4) equalizes expected marginal benefits and costs of contributing G. Denote the solution to (4) by $G(s)$. The following proposition shows that any "$|s|$-pres" protection of donor restrictions is better than no protection at all from the donor's viewpoint.

[12] This can be guaranteed by imposing "Inada" conditions (marginal utility becoming arbitrarily large as $G \to 0$.

Proposition 1 *Introducing a legal protection $s < n$ on donor restrictions induces a higher level donations: $G(s) > G(n)$. The closer is s to zero, i.e., the stricter the protection, the higher is the donation $G(s)$.*

Proof. The proof follows from the first-order conditions (3) and (4). Suppose, contrary to the claim, that $G(s) = G(n)$, hence $C(s) = C(n)$. Let

$$X(l,q) = \frac{\partial U(C(l),G(l),q)}{\partial G} - \frac{\partial U(C(l),G(l),q)}{\partial C},$$

denote the net marginal benefit from contributing $G(l)$ when policy l will be implemented with probability one, under $|l|$-pres protection of donor restrictions. The first-order conditions (3) and (4) can now be written as

$$\sum_{\omega=-n}^{n} p(\omega)X(n,q^*(\omega)) = 0 \tag{3'}$$

and

$$\sum_{\omega=-s}^{s} p(\omega)X(s,q^*(\omega)) + [\sum_{\omega=-n}^{-s-1} p(\omega) + \sum_{\omega=s+1}^{n} p(\omega)]X(s,\tilde{q}(s)) = 0. \tag{4'}$$

Since $G(n) = G(s)$ is assumed, $\sum_{\omega=-s}^{s} p(\omega)X(n,q^*(\omega)) = \sum_{\omega=-s}^{s} p(\omega)X(s,q^*(\omega))$. Using this and $\sum_{\omega=-n}^{n} p(\omega)X(n,q^*(\omega)) = 0$, (4′) can be written as

$$\sum_{\omega=-n}^{-s-1} p(\omega)X(n,q^*(\omega)) + \sum_{\omega=s+1}^{n} p(\omega)X(n,q^*(\omega)) = [\sum_{\omega=-n}^{-s-1} p(\omega) + \sum_{\omega=s+1}^{n} p(\omega)]X(s,\tilde{q}(s)),$$

or, rearranging terms, as

$$\sum_{\omega=-n}^{-s-1} p(\omega)[X(n,q^*(\omega)) - X(s,\tilde{q}(s))] + \sum_{\omega=s+1}^{n} p(\omega)[X(n,q^*(\omega) - X(s,\tilde{q}(s))] = 0. \tag{5}$$

This condition holds if $X(n,q^*(\omega)) = X(s,\tilde{q}(s))$, where $q^*(\omega) \in N(s)$ and $\tilde{q}(s) \in S(s)$. Recall the assumption that donor's marginal and absolute utility are both higher, given C and G, under policy $|q_1|$ than under $|q_2| > |q_1|$. Therefore, since $q^*(\omega) \in N(s)$ and $\tilde{q}(s) \in S(s)$, $|q^*(\omega)| > |\tilde{q}(s)|$ and the donor's utility under policies $\tilde{q}(s)$ is higher: $U(C(n),G(n),q^*(\omega)) < U(C(s),G(s),\tilde{q}(s))$. Since marginal utility should also be higher, $X(s,\tilde{q}(s)) > X(n,q^*(\omega))$. Then the left hand side of (5)

is strictly negative, a contradiction. This implies that the donor increase the size $G(s)$ of the gift above $G(n)$, so that $G(s) > G(n)$. That $G(s)$ is decreasing is s follows from similar arguments. Q.E.D.

Proposition 1 formalizes a concern that is sometimes expressed in recent debates over cy pres reform: relaxing protection of donor restrictions erodes incentives to donate. Because donors derive utility from influencing future charitable policies, reducing their prospective control induces them to allocate more funds to alternative, rather consumptive, uses. The analysis should be pursued further, however, to investigate the solution to the problem of devising rules that satisfy best the following conflicting objectives: (i) inducing higher donations and (ii) promoting social welfare by allocating these donations to their optimal uses.

Consider, then, the law maker's problem of determining of s. What level of protection should be applied to donor restrictions on gifts to charitable trusts? Or, how "pres" should the courts enforce donor restrictions?

The objective of the law maker is to choose the protection level that maximizes a social welfare function, postulated to represent the society's preferences. I impose two basic conditions: The society prefers more funds for charitable policies and has preferences over lotteries on the set of policies. Let $V(q^*(\omega), q(\omega), G)$ denote social welfare when, ex-post, policy $q^*(\omega)$ is optimal while trustees choose policy $q(\omega)$ with funds G. $V(q^*(\omega), q(\omega), G)$ is increasing in G and is maximal, given G, if $q(\omega) = q^*(\omega)$. In equilibrium, given s, the donor's contribution $G(s)$ and the trustees' strategy $q(\omega)$, social welfare will be

$$V(q^*(\omega), q(\omega), G) = \begin{cases} V(q^*(\omega), q^*(\omega), G(s)) & \text{if} \quad |\omega| \leq |s|\,; \\ V(q^*(\omega), \tilde{q}(s), G(s)) & \text{if} \quad |\omega| > |s|\,, \end{cases}$$

where, recall, $\tilde{q}(s)$ is the "second best" policy to which the trustees deviate when the optimal policy lies outside the set $S(s)$. The trustees will be able to choose the optimal policy $q^*(\omega)$ whenever $\omega \leq |s|$, that is, whenever $\omega \in S(s)$. Then, expected social welfare can be expressed as:

$$EV(q^*(\omega), q(\omega), G(s)) =$$

$$\sum_{\omega \in S(s)} p(\omega) V(q^*(\omega), q^*(\omega), G(s)) + \sum_{\omega \in N(s)} p(\omega) V(q^*(\omega), \tilde{q}(s), G(s)). \qquad (6)$$

The first term represents the expected welfare corresponding to "states" in which optimal policies can be implemented (for $\omega \in S(s) = \{-s, \cdots, 0, \cdots, s\}$) while the second term represents the expected payoffs when the optimal policies cannot be applied due to effective protection of donor restrictions. The trade-off involved in the choice of s is apparent in (6):

Proposition 2 *A strict protection of donor restrictions will, as shown in Proposition 1, induce high levels of donations, but also generate ex-post inefficient uses of funds with a higher probability, and vice-versa.*

Keeping $G = G(s)$ constant, a larger value for $|s|$ will increase expected social welfare because it allows for a greater flexibility in the choice of future policy q. In terms of (6), a higher value of s increases the number of "states" in which the optimal policy $q^*(\omega)$ can be implemented and the maximal welfare $V(q^*(\omega), q^*(\omega), G(s))$ be realized, while decreasing the number of "states" in which only second-best policies are implemented to yield the lower welfare $V(q^*(\omega), \tilde{q}(s), G(s))$. But $G(s)$ will not remain constant; the greater flexibility in choosing future policies reduces the donor's willingness to make a charitable gift, which decreases $G(s)$, hence social welfare in all future possible "states". The optimal protection of donor restrictions, $|s^*|$, should balance these two effects. More precisely, $|s^*|$ satisfies

$$EV(q^*(\omega), q(\omega), G(s^*)) \geq EV(q^*(\omega), q(\omega), G(s)) \quad \text{for all} \quad s \in \Omega.$$

I discuss below the impact of relaxing two assumptions of the model, on the optimal value of $|s|$.

First, the analysis above assumes that ex-post the trustees always implement the socially optimal policy. How should the $|s|$-pres doctrine be modified to safeguard against the possibility that the trustees' pursue their own private goals with a deceased donor's funds? Now the law maker has to consider, besides the tradeoff between restrictions and donations highlighted above, the fact that the trustees will

not necessarily choose the socially optimal policy within the $|s|$-pres restriction. Let ω^0 denote the realized policy option that is the best from the trustees' viewpoint. Given the set $S(s) = \{-s, ..., 0, ..., s\}$ of admissible policies, the trustees' (individually) optimal policy in (1) will be modified as follows: Choose $q = \omega^0$ if $\omega^0 \in S(s)$. If $\omega^0 \notin S(s)$ then choose $q = \tilde{s}$ where $\tilde{s} = s$ or $\tilde{s} = -s$ is the second-best policy in the set $S(s)$ from the trustees' viewpoint.

Let $\pi(\omega)$ denote the probability that state ω is the trustees' optimal policy ex-post. In the absence of a restriction on ex-post policies, the trustees will use funds in a policy ω that is not socially optimal if ex-post the realized the state is $s \neq \omega$. There are two instances in which the trustees will implement the (unconstrained or constrained) optimal policy: (i) Trustees' optimal and social optimal policies are in the admissible set S and they coincide. This happens with probability $\sum_{\omega \in S} p(\omega)\pi(\omega)$. (ii) Trustees' optimal and social optimal policy are in the nonadmissible set N but both lie at the same tail of N. This happens with probability $\sum_{\omega=s}^{n} p(\omega) \sum_{\omega=s}^{n} \pi(\omega) + \sum_{\omega=-n}^{-s} p(\omega) \sum_{\omega=-n}^{-s} \pi(\omega)$. In all other cases, the trustees will pick a socially suboptimal policy. Ex-ante, the impact of this possibility on expected social welfare depends on the expected difference between the trustees' and society's preferences. Obviously if $\pi(\omega)$ is almost equal to $p(\omega)$ for all ω, the impact would be negligible. From the law maker's point of view, the relevant issue is how distant the trustees' expected optimal policy is from the expected socially optimal policy. The following conclusion can be drawn:

> *If the trustees' optimal policy is expected to be further away from, while the socially optimal policy is expected to be further closer to, the donor's most preferred policy $\omega = 0$, the optimal $|s^*|$-pres protection of donor intentions is likely to be more restrictive (i.e., $|s^*|$ will be smaller).*

The intuition can be grasped from an extreme example. Suppose that ex-ante, the socially optimal policy is known with certainty to coincide with the donor's intention. Stated differently, donors' preferences and social preferences will coincide with probability one. Then, to prevent the trustees from implementing a policy

$\omega \neq 0$, the first-best legislation involves the most restrictive application of the *cy*-pres doctrine: no divergence from the donor restriction is allowed. This logic extends to the case in which the ex-post socially optimal policy is uncertain but very likely to be one of the few in the neighborhood of the donor's intended policy. Then, if the trustees' policy preferences are expected to lie in policies that are more distant from the donor's intended policy, the optimal response of the law maker should be to apply a more restrictive version of the *cy*-pres donctrine. Note that such a response will also have a positive impact on the amount of donations.

The second assumption of the model is that donors are not strategic in purpose setting.[13] The donor's most preferred policy is $\omega = 0$ and he recommends this policy under all possible applications of the cy-pres doctrine. However, the donor may engage in strategic purpose setting if he anticipates that ex-post the socially optimal policy is likely to be biased and away from $\omega = 0$. To show this, consider the extreme example where $p(\omega) = \epsilon$ for $\omega < 0$ and ϵ very small. Given $|s|$-pres application of the donor's intended policy, the donor will strategically announce $-s$ as the intended policy, and have his true intention $\omega = 0$ implemented ex-post with probability one, assuming that trustees implement the best social policy from the set $S(s) = \{-2s, ..., -s, ..., -1, 0\}$. Modifying the purpose of donations strategically in response to expectations about future policies may lead to large welfare losses. Then, a more restrictive application of the *cy*-pres doctrine is called for, to reduce the scope for strategic purpose setting.

4 Conclusion

The interpretation and applications of the cy pres doctrine have attracted considerable attention from legal scholars, in particular during the last decade. I close the paper with a brief discussion of the debate on reforming the present practice of the doctrine in light of the analysis presented above.

Authors favoring the reform of the cy pres doctrine advocate more flexibility

[13] I would like to thank a referee for bringing this issue to my attention.

in the rules protecting donor intentions, so that more power is shifted to the state or trustees in administering modifications of donor-restricted charitable purposes.[14] Though the present strict version of the doctrine has generated only minimal operational and interpretive difficulties, it continues to induce rather maximal inefficiency and waste of social welfare, viewed from both ex-ante and ex-post perspectives. The lesson of the preceding analysis, however, is that the appropriate criterion to evaluate the doctrine or its reform is ex-ante efficiency, encompassing the impacts of a reform on both donor incentives (ex-ante) and expected social welfare losses (ex-post).

One reform strategy is to allow courts to infer, not strictly honor, donor preferences and determine the best actual charitable policy on the basis of what an average reasonable donor would prefer it to be under the given circumstances. If it were possible to resurrect the dead hand in this model and ask what policy to adopt given that her most preferred policy $q = 0$ is grossly inefficient, her answer would be $q = 1$ or $q = -1$, the closest policy to $q = 0$. This is also what a strict application of the cy pres doctrine (with $s = 1$) suggests would happen: the deviation, if any, would be to the policy nearest to donor's initial restriction. If donors on average have general charitable intents, besides their specific intents formulated in the restrictions they impose, then a reform to implement the policy that the average living donor would prefer makes sense. The problem with this criterion lies in its application. To the extent that it is impossible to infer the average donor's preferences, the courts will develop their own criterion for what they believe to be the average donor's preferences. If the preferences used in modifying charity purposes do not correspond to the average donor preferences (they may overprotect or underprotect donor restrictions relative to the preferences of the average donor) the behavior of present donors will be affected. Underprotection will generate too little donations though what is donated will be used more efficiently, ex-post.

Another approach is to rely exclusively on ex-post efficiency, with no reference to donor preferences. Implementing this approach under the supervision and en-

[14] See, e.g., Brody (1998).

forcement of courts would be very costly, however. But ignoring the costs of its implementation, this approach (corresponding to the case $s = n$ in the model) produces ex-post efficient charitable outcomes from the social point of view and has the advantage of eliminating the possibility of strategic purpose setting. As the model predicts, however, this rather extreme type of reform would induce prospective donors to opt out if they correctly anticipate that their intentions will almost surely not materialize, either because the socially optimal policy is deemed quite different or the trustees implement their own preferred policy.

To balance the donations effect and the ex-post efficiency effect of relaxing dead hand control over restricted funds, the middle road would be to set a bound $s = k$ on donor protection, between zero (full protection) and $s = n$ (no protection). Atkinson (1993) points to practical difficulties (e.g., defining efficiency and criteria to be used in modifying donor restrictions) associated with implementing such an approach and suggests relying exclusively on the board of trustees to determine charity policies. Ignoring the potential moral hazard problem associated with this approach, the role of the courts would then be reduced to monitoring the policies of trustees to determine whether the duties of care and loyalty are not violated. The assumption that trustees can perform the exercise of allocating funds efficiently without difficulty and violation of their duties seems far-fetched, unfortunately.[15] One of the justifications that Atkinson uses in defense of his suggestion is that liberating the state from its duty to administer modifications in charities' purposes would economize on enforcement costs. It is not clear, however, whether the costs of administering a moderately flexible donor protection policy would exceed the agency costs under Atkinson's reform proposal, which would require constant monitoring of the boards when the trustees enjoy ample freedom in choosing their policies.

[15] See Manne (1999) for convincing arguments supporting this claim.

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