

Professional Notes

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TAX & ESTATE PLANNING | NONPROFIT LAW



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DAFs in the News: Judges Push Back on Donors Who Go to Court

Donor-advised funds, or DAFs, are popular with donors and their advisors, and they attract billions annually in charitable giving. One study estimates that nearly \$39 billion flowed into DAFs in 2019 alone.¹ With popularity and large sums of money comes controversy—in the media, the courts, and even in Congress. In this edition of ProNotes, we consider one forum of DAF controversy: two recent litigations in the Federal District Court for Northern California brought by donors displeased with the administration of the DAFs they had established. In both cases, the defendant DAF sponsors were organizations associated with commercial investment advisors (Fidelity Investments in one case and Charles Schwab & Co. in the other). So far, the donors have not prevailed. But the facts and the outcomes are nonetheless instructive about the misalignment that can occur between the expectations of donors and the practices of DAF sponsors. And while the context of “commercial” DAF sponsors may be particularly ripe for this type of misalignment in expectations, the ever more common perception of DAFs as financial “accounts” of the donor, like a brokerage account or a savings account, creates the conditions for trouble at DAFs everywhere. The court rulings in these two cases analyze questions about legal standing and the contours of DAF advisory privileges in ways that may have an important impact on how sponsors, donors, and their advisors think about DAFs.

Written by Carrie Trowbridge, General Counsel, The New York Community Trust, with special thanks to John Sare of Patterson Belknap Webb & Tyler LLP. This material was developed for the use of professionals by The New York Community Trust. It is published with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice.

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¹ See National Philanthropic Trust's 2020 *Donor-Advised Fund Report*, available at <https://www.nptrust.org/reports/daf-report/>.

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Why Litigation? Why Now?

The New York Community Trust introduced the first DAF in 1931, and since that time community foundations throughout the country have used DAFs as a way of connecting donors with charitable causes and making philanthropy accessible to those who do not have the means to establish other, more costly structures (such as creating a private foundation). Financial institutions stepped into the DAF space in 1991, when Fidelity Investments established Fidelity Investments Charitable Gift Fund (“Fidelity Charitable”), the first DAF sponsor associated with a financial institution. That initiative was quickly followed by other “commercial” DAFs. As investment advisors, financial planners, lawyers, and donors gained increasing familiarity and comfort with DAFs, the flow of money into these funds swelled, and DAFs became an increasingly popular philanthropic vehicle across the country. At The Trust, we have long supported our DAF donors by performing due diligence on grantees and making our grantmaking expertise available to donors interested in that guidance. But the core appeal of DAFs—distinct from how particular DAF sponsors may operate their DAF programs—is the ability of donors to separate their immediate tax planning needs from the fulfillment of their charitable goals and to avoid the administrative aspects of grantmaking that become the responsibility of the DAF sponsor.

The separation in time between a contribution to a DAF and the ultimate distributions from the DAF to operating charities is the feature of DAFs that has

garnered the most scrutiny from a handful of academics, charities activists, and critics in government, who argue that the assets in DAFs should be moved more quickly into the hands of operating charities.² For donors of a litigious bent, though, DAFs have been in the crosshairs for another reason: thwarted expectations around investment activities within a DAF, including the timing and strategy for liquidating securities donated to a DAF and the expenses associated with the DAF sponsor’s investment decisions.

Fairbairn v. Fidelity Charitable

Investors Emily and Malcolm Fairbairn filed a lawsuit in the District Court for the Northern District of California in 2018 claiming, among other things, intentional misrepresentation, breach of contract, and negligence on the part of Fidelity Charitable, the DAF sponsor associated with Fidelity.³ The Fairbairns asserted that Fidelity had made certain promises to induce them to donate a large block of the tech stock Energous to a Fidelity Charitable DAF and that, failing to keep its promises and breaching an alleged duty of care owed to the Fairbairns, Fidelity Charitable sold the stock in an irresponsible way that drove down the share price, reducing the value of their contribution and therefore both their tax deduction and the charitable assets available for grantmaking in the Fairbairn DAF. The Fairbairns had transferred 700,000 shares of Energous stock on December 27, 2017 and 1.23 million on December 29, 2017. Fidelity Charitable sold all 1.93 million shares on the afternoon of December 29, the last trading

² This has been the case despite studies showing that the aggregate annual payout rate of DAFs is over 20% (as contrasted with the 5% minimum payout rate applicable to private foundations). *See supra* note 1.

³ *Fairbairn v. Fidelity Investments Charitable Gift Fund*, No. 18-cv-04881-JSC (N.D. Cal.). Fidelity Charitable is legally separate from Fidelity and was granted tax exemption by the IRS, though according to discovery in the case and other publicly available information, Fidelity staff perform services for Fidelity Charitable via a master services agreement, and Fidelity manages assets of Fidelity Charitable.

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day of the year, for proceeds of approximately \$44 million. The Fairbairns claimed a \$52 million income tax charitable deduction for their gift, presumably calculated on the basis of the average high and low trading prices on the two days when they made their gifts. The Fairbairns claimed that Fidelity Charitable had promised, among other things, that it would not sell the stock until 2018 and that it would let the Fairbairns advise on a liquidation price and that by “irresponsibly” selling the thinly traded stock in the last few hours of the last trading day of the year, Fidelity Charitable drove down the stock price. Fidelity Charitable, for its part, asserted that it had made no such promises and had followed its policies on stock sale, which had been communicated to the Fairbairns.

In November 2018, the court held that the Fairbairns had standing to bring suit under both the law of California (where the Fairbairns live) and the law of Massachusetts (where Fidelity Charitable is based). The analysis under the laws of both states was very similar, with the court finding that, under California law, the plaintiffs had alleged a “special relationship” sufficient to confer standing to sue regarding the disposition of their donation, based on the “exclusive advisory rights” the donors retained over the fund. Analyzing Massachusetts law, the court similarly concluded that the donors had asserted interests that are “distinct from those of the general public” because their “robust” advisory privileges constituted “specific and unique future rights” with respect to the DAF. Plaintiffs made a point of alleging that the “rights” Fidelity Charitable had granted them with respect to disbursements from the fund were greater than those generally accorded to DAF donors by DAF sponsors.

Despite the court’s solicitude on the issue of donor standing, it ultimately ruled against the Fairbairns on the merits, concluding in February 2021 that the evidence did not support their allegations concerning the promises Fidelity Charitable had made to them. One alleged fact that has been widely reported in the press was an alleged promise by Fidelity Charitable not to sell more than 10 percent of the publicly traded volume on a given day, but contrary to the Fairbairns’ allegations, the court ultimately found that Fidelity Charitable had made good on that promise.

Under California law, a claim for negligence is generally not available in the case of purely economic loss, but there is an exception where the plaintiff and defendant have a “special relationship,” which exists where the plaintiff was an intended beneficiary of a particular transaction and was harmed by the defendant’s negligence in carrying it out. As the court analyzed a multi-prong set of considerations relevant to a finding of a “special relationship,” the court cited the benefit of an immediate tax deduction and the “right to pass on their DAF to their children,” among other things. The court ultimately found that those facts alone were not sufficient to find a duty of care under California law and that the court did not need to resolve the question anyway—because, even if a duty of care was owed, there was no evidence that it had been breached. By grounding its ruling on the duty of care in a factual finding about the absence of any breach of even a hypothetical duty of care, the court effectively insulated its decision from successful appeal—perhaps one of the reasons the Fairbairns elected not to appeal the court’s decision.

In theory, the *Fairbairn* case does not turn on the fact that a DAF was involved. It is

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Communicating to donors what privileges are encompassed in a DAF's sponsor's "advisory privileges" and adhering to those policies would seem the best prophylactic against mismatched expectations.

conceivable that a donor could sue an operating charity (such as a university or hospital) based on post-gift investment decisions by the charity that allegedly are in breach of promises the charity made to induce the gift. On the other hand, DAFs may be uniquely vulnerable to such claims given the donor's ongoing involvement in decision-making (with the donor's advisory privileges elevated to the status of "rights" in the *Fairbairn* court's terminology) as well as the room for variation among DAF sponsors around what the advisory privileges entail. This seems even more likely to the extent that DAFs are promoted—and seen—as financial accounts rather than what they are, which is gifts to charity.

The result in *Fairbairn* means, at least in California and Massachusetts, that "robust advisory rights" with respect to a DAF may confer standing to sue with respect to promises allegedly made by the DAF sponsor to the donor. How "robust" do advisory privileges need to be in order trigger that finding? Could all DAF donors potentially have sufficiently robust advisory rights to litigate specific promises allegedly made to them about the DAFs they established? The exact contours of the duty of care allegedly owed to donors by DAF sponsors also remain uncertain. Might some other set of facts prompt a court to find that there is a duty of care?

Despite these questions, one take-away is clear: the written policies of the DAF sponsor, the DAF sponsor's oral and written representations to prospective donors, and the record of the DAF's sponsor's management and investment of assets will bear importantly on the outcome in court if a disappointed donor decides to bring suit. Communicating

to donors what privileges are encompassed in a DAF's sponsor's "advisory privileges" and adhering to those policies would seem the best prophylactic against mismatched expectations.

Pinkert v. Schwab Charitable

In granting donor standing, the *Fairbairn* court emphasized that the Fairbairns were not making claims about the handling of DAFs by Fidelity Charitable generally, just about the handling of the Fairbairn DAF. But the plaintiff in *Pinkert v. Schwab Charitable Fund* went a step further, arguing that Schwab Charitable Fund ("Schwab Charitable") mismanaged its DAFs generally.⁴ The gravamen of the lawsuit was that Schwab Charitable breached its fiduciary duties by investing Schwab Charitable DAF assets in Charles Schwab & Co. investment vehicles that had higher fees than comparable funds at other financial institutions. The plaintiff argued that the decision by Schwab Charitable to use these more expensive vehicles was driven by an inherent conflict of interest built into its relationship with Charles Schwab & Co. If that relationship had not been present, the plaintiffs' reasoning ran, Schwab Charitable would have invested in cheaper options rather than the more expensive Charles Schwab & Co. vehicles (or perhaps would have negotiated fee reductions from Charles Schwab & Co.). As was the case of *Fairbairn*, the plaintiff alleged he was harmed by a diminution in the DAF balance as a result of the defendant's actions, which meant there was less available for grantmaking out of the DAF.

Importantly, the duties allegedly breached

⁴ *Pinkert v. Schwab Charitable Fund et al*, No. 20-cv-07657 (N.D. Ca. 2021).

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The combination of donor responsiveness and community commitment makes our DAF program distinctive—a platform for philanthropy, not just another “account.”

were Schwab Charitable’s duties as the fiduciary steward of charitable funds, not its duties to the plaintiff in particular. This de-personalizing of the allegations provided the plaintiffs the grounding principle for filing the case as a class action. *Pinkert* was filed on behalf of all “account holders” at Schwab Charitable whose donor-advised funds allegedly all had lower balances available for charitable grantmaking than they would have had if the fees had been (in the plaintiff’s view) appropriate.

In June 2021, a magistrate judge in the Federal District Court for the District of Northern California granted Schwab Charitable’s motion to dismiss, distinguishing the facts of the case from *Fairbairn* and ruling that the plaintiff did not have standing to proceed. The court concluded that the plaintiff had ceded control of the donated assets in exchange for the tax deduction and that his DAF advisory privileges did not amount to a contractual or property interest whose invasion could result in “concrete and particularized” injury. This was a very significant decision for DAF sponsors. A contrary decision could have opened the door to broad-based challenges by donors unhappy with any number of decisions made by sponsoring organizations with respect to investment decisions made within DAFs. The plaintiff, however, is appealing the decision, so *Pinkert* is a case we will continue to follow.

A Charitable “Account”?

In *Pinkert*, the term “account holder” seemed to drive the plaintiff’s argument for standing—the notion being that the putative class of claimants had rights because the case concerned “their” accounts, just like any

other financial account the plaintiffs might have at Schwab. In *Fairbairn*, the emails that surfaced during discovery painted a picture of parties interacting with each other as if the Fairbairns were brokerage clients of Fidelity, the financial services company, rather than Fidelity Charitable, a public charity. This view of the DAF seemed to be the starting premise for the plaintiffs in both cases.

The courts have taken a different view. The decision in *Pinkert* is consistent with the fundamental nature of DAFs as they have been traditionally conceptualized and understood in the charitable sector: a DAF is not an “account” in which the donor has an ongoing and direct economic stake of the type that should support legal claims but rather a completed gift to charity (the DAF sponsor).

At The Trust, the fact that we are a charitable organization is essential to how we define and manage our DAF program. Indeed, the origins of the DAF were as a tool The Trust could offer donors who wanted to establish permanent funds for the community but also wanted the ability to recommend particular grants from time to time during their lifetimes. To this day, if there are still funds in a DAF once the donor’s designated advisors have died or stepped down, those remaining funds become part of The Trust’s competitive grants program, supporting organizations in our geographic community. We also perform due diligence on all recommended grantees and offer advisors professional advice about effective deployment of DAF funding in the communities we serve. This combination of donor responsiveness and community commitment makes our DAF program distinctive—a platform for philanthropy, not just another “account.”

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