

# Patagonia, Purpose Trusts, and Stewardship Trusts— Business with a Purpose

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**O**n September 16, 2022, news media reported that Yvon Chouinard and his family had transferred voting control of Patagonia to a purpose trust and their nonvoting interests in the company to a 501(c)(4) nonprofit organization. The purpose trust will manage Patagonia as a for-profit company, continuing Chouinard's emphasis on employee well-being. Profits from the company will be distributed to the nonprofit, which will support efforts to address climate change and work to protect undeveloped land.

The noncharitable perpetual purpose trust used by Patagonia is referred to as a stewardship trust in Oregon, Or. Rev. Stat. § 130.193 (2019). This strategy for business ownership is finding increasing interest among founders who want to protect their businesses' missions into the future. A purpose trust ownership structure can hold a business accountable to a business's founding purpose, such as protecting the environment or promoting education. The purpose can also include providing employee control of the business and an emphasis on benefits for employees. The purpose is integral to the trust, with all decisions being made in furtherance of the trust and, therefore, in furtherance of the purpose. The trust operates without beneficiaries and may seek both economic benefits, like profit, and noneconomic benefits, like the ones described in this paragraph.

Although this structure seems to resemble a charitable trust because of the lack of ascertainable beneficiaries, the trust has a noncharitable purpose. The business held by the trust generates profits and uses these profits in furtherance of the purpose. Instead of generating profits for shareholders, the trust is held accountable to its purpose above all else. Therefore, organizations that follow this structure are able to stay true to the purposes of the trust and operate into the future. The structure allows firms to maintain profitability and operate outside of the nonprofit realm while still being socially responsible and carrying on the central purpose the founders envisioned. The structure can be particularly helpful for family businesses with owners who want to retire but who do not have family members to take over the business. If the family business owners care about their employees, the community, or other noneconomic purposes, they may be able to use the stewardship trust model as a way to preserve the business for posterity.

This novel form of business structure varies significantly from the traditional models of ownership used by most companies. Typically, noncharitable trusts are required to have discernable beneficiaries, but, under some state statutory regimes, noncharitable trusts can now be created without beneficiaries. These statutes allow a trust to be organized around its purpose, instead of on behalf of its beneficiaries, and in some states the trust can last in perpetuity. Uniform Trust Code (UTC) § 409, under which a trust can be created for a noncharitable purpose, has not been adopted in every state, and some of the UTC states still apply the rule against perpetuities to purpose trusts. In addition, UTC § 409 allows a court to reduce the amount held in a purpose trust if the court determines "that the value of the trust property exceeds the amount required for the intended use." UTC § 409(3). Even if the business is in a state that does not yet

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provide for perpetual purpose trusts by statute, the business owners might use an Oregon stewardship trust to hold the business. The stewardship trust may be an enticing tool for business organization for many companies, particularly small businesses.

The structure of a stewardship trust may at first seem complicated. In this model for business ownership, the trust owns the business, Or. Rev. Stat. § 130.193(2), and the business operates mostly as normal. The trust replaces private owners or shareholders who would otherwise own the company in a traditional business model. Unlike other trusts, the stewardship trust has a stewardship committee composed of various stakeholders like employees, nonvoting shareholders, and community members, and the committee directs the trustee in the administration of the trust. A stewardship trust operates as a directed trust, with the stewardship committee directing the trustee with respect to the management of the trust's assets.

A stewardship trust also has at least one trust enforcer who ensures that the trustees and the committee operate the trust in the interest of the founding purpose. Or. Rev. Stat. § 130.193(3). This second level of accountability to the founding purpose makes the business structure more rigid, yet it enforces the company's commitment to its purpose. The trustee or trustees are appointed by the trust stewardship committee, and these trustees manage the operation of the trust, as directed by the stewardship committee. *Id.* § 130.193(10). The stewardship committee has the duty of informing both the trustees and trust enforcers about the administration of the trust. *Id.* § 130.193(9). In general, the committee members, the trustees, and the trust enforcer all work together to ensure that the goals of the trust are being accomplished and that the business is being operated smoothly. The normal business operations will still require separate management, such as a board of directors, if the business is organized as a corporation. These directors or other managers will be accountable to the trust instead of to shareholders.

The stewardship trust ownership structure may seem rigid, and that is the point. If a stewardship trust could easily change its purpose, then business owners would have little reason to choose this structure over a more standard form that values profit over purpose. Modifying the trust is rather difficult as well, requiring the unanimous agreement of the stewardship committee and the trust enforcers, or, alternatively, action in court, to alter the terms of the trust. *Id.* § 130.193(10)–(11). Further, the system of checks and balances that spreads authority across the stewardship committee, the trustees, and the trust enforcers ensures that the business operations are serving the best interests of the trust. This barrier to structural change provides the stability this kind of business structure needs to be accountable to its overarching purpose, but the structure is not so limiting as to prevent the growth of the business over time. Indeed, the purpose of the stewardship trust should be broad and flexible enough to account for innovation or expansion of the business.

Two case studies explore some of the advantages and disadvantages of the stewardship trust model for corporate governance. These case studies are hypothetical, built from a study of several companies considering the stewardship trust structure. The hope is that these case studies will help other companies (and their advisors) think through the issues involved in a transition to steward ownership using a trust.

### **Case Study #1: Educational Resources and S Corporations**

#### *A Mission-Driven Company*

The first case study involves an educational resources company (Edu Resources) owned by its founder and current CEO. The founder wants to retire fully in the near future. Although strong leadership within the company can take over and run the company after the CEO leaves, the owner, as its founder, wants to ensure that the company will continue to be governed by the socially constructive purpose with which

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the company was created. The company is profitable, so the owner could sell it, but new owners might eliminate many of the company's more socially responsible programs.

Edu Resources specializes in providing online educational resources and reinvests most of its profits into its social mission, through the development of new educational programs and further research. The owner would like to transition the company from its current governance structure to being held in a stewardship trust, but the transition raises questions about how assets are moved from the existing company into the trust, with a number of difficult tax issues to consider.

### *S Corporation Structure*

Like many companies owned by a small number of people, Edu Resources is structured as an S corporation. An S corporation passes the income earned by the corporation through to its shareholders, who individually pay the taxes on that income. S corporations are thus taxed only once, at the individual level, and not at both the corporate and individual levels. The result is a lower effective rate compared to many other governance structures, although limitations on which companies can use the S corporation structure exist so that not every company can take advantage of this tax benefit. S corporations can have no more than 100 shareholders, and shareholders must be individuals. Also, S corporations can have only one kind of stock. These structural controls limit the widespread use of S corporations but allow the shareholders of smaller corporations, like Edu Resources, to avoid double taxation on their income.

Unlike the tax treatment for S corporations, any income that remains in a trust is taxed in the trust. Trust income reaches the highest tax rate much more quickly than income taxed to an individual, IRC §§ 1(e), 641, so a structure that has taxable income at the trust level will not be beneficial. Settlers of stewardship trusts, like the owner of Edu Resources, will want the trust to own the company but operate the company so that little income is distributed by the company to the trust.

A stewardship trust cannot own stock in an S corporation because S corporation stock cannot be owned by nonindividuals. Therefore, the company will need to reincorporate as a C corporation, which has its own unique challenges. The transition from an S corporation to a C corporation does not have an immediate tax consequence, but when the stock is owned by the C corporation, the stock will be taxed at the corporate level and then again at the individual level if the corporation distributes dividends to owners.

The founder of Edu Resources wants to receive distributions from the company for a few more years. Until the founder transfers all the stock to the trust, distributions made from the C corporation to the founder will be taxed both at the corporate level and at the founder's level. This double taxation makes the transition process less appealing to the founder, who is currently taxed only once as the owner of a Subchapter S company. Once the trust owns all the stock of the company, the double taxation can be avoided. The C corporation will use most of the profit at the corporation level so that only minimal income is distributed to the trust—just enough to pay the costs of administration. For example, the corporation can hold some profit for research and development and for profit-sharing for employees.

### *The Transition Process*

After the company has been reincorporated as a C corporation, ownership of the company will be transferred to the trust. Either the trust will need to purchase the stock, or the owner may transfer the stock as a gift to the trust. Both methods come with advantages and disadvantages, so the choice of method will depend on factors such as the state where the business pays its taxes and its applicable tax rates, the number of owners of stock in the company, the amount of assets the trust owns, and the availability of financing tools, such as loans, to the trust.

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If a company has numerous shareholders, none of which has a majority share, the shareholders will likely need to sell shares to the trust for it to gain ownership. This can be accomplished by first creating the trust and using financing tools, such as a loan from an impact investor or a small business administration loan, to buy the stock from shareholders. Alternatively, if the company has lots of cash on hand, it may wish to buy back the stock first and then make a gift transfer to the trust. Many S corporations may lack sufficient liquid assets to buy back the stock, but a company stock purchase strategy may work for some businesses hoping to use the stewardship trust model, such as a company with an ESOP that has numerous employee-owners.

For corporations with few shareholders, like Edu Resources, a different strategy is available. If one or two people own all the shares of the company, the owners can create the stewardship trust without the need to buy back stock from other investors. Oregon still has an estate tax but does not have a gift tax, so the owner may transfer ownership of the company's assets to the trust as a gift without Oregon gift tax concern. In addition, the federal gift tax applies only when a donor has made cumulative lifetime gifts in excess of around \$12 million. The federal gift tax may be relevant for some larger firms transitioning to steward ownership, but for many smaller companies, like Edu Resources, a gift will be under the federal amount, at least as currently calculated. Congress may reduce the amount, and if Congress does nothing, the amount will revert to a lower amount (\$5 million adjusted for inflation) at the end of 2025, so the federal transfer tax may prove to be a concern even for smaller companies.

The owner of Edu Resources has decided to transfer ownership of the company to the stewardship trust gradually, in order to continue to earn income for a few more years and to maintain oversight over the business. The company will first convert to a C corporation—so that the trust can own stock in the company—and the owner will then sell stock to the stewardship trust in \$500,000 installments over the next eight years. Because the sales price of \$4 million is lower than the fair market value of the company (\$8 million), portions of each installment will be treated as a gift. Alternatively, the transition could be structured as a gift of half the stock in the first year, followed by the sale of the other half spread over eight years. Either way, the owner will continue to earn income throughout the change in governance of the company, and the sales proceeds will fund the owner's retirement.

The disadvantage of this transition strategy, which includes conversion to a C corp, is that income tax will be generated at the corporate level and then again at the individual level as the shares are sold. Instead, the owners of Edu Resources might decide to continue to operate the company as an S corporation and make distributions to themselves until the \$4 million is distributed. At that time, they would make a gift of their remaining interests in the company to the trust. The stewardship trust would not be created until the owners were ready to make the gift of the remaining interests in the company, but the planning could be done in advance.

The risk of any delay in transferring the business to the trust, either through an installment sale or by waiting until value is distributed to the owners, is that the owners may die before completion of the transfer of the stock to the trust. This risk is of particular concern for company owners who are older or worried about their health. The Oregon estate tax applies to an estate in excess of only \$1 million, so owners of an Oregon company may wish to expedite the process so that the owner's estate will not have to pay an estate tax should the owner die before the owner's interest in the company has been completely transferred to the stewardship trust. An expedited transfer can be accomplished by structuring the stewardship trust as an intentionally defective grantor trust (IDGT).

### **Intentionally Defective Grantor Trust**

An IDGT is a trust that is treated as a grantor trust for income tax purposes, with the result that the

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trust's income will be taxed to the grantor. As a grantor trust, the trust can purchase stock from the owner without immediate tax consequences. The owner is selling stock to the trust, but because the trust is a grantor trust, for tax purposes the sale is from the owner to the owner. The sale by the owner to himself is not a taxable event.

To cause the trust to be treated as a grantor trust, the trust is structured to give the owner a power that will trigger grantor trust treatment under IRC § 674. The power causes the income to be taxed to the owner (the grantor) without causing the trust to be included in the owner's estate for estate tax purposes. For example, the owner might retain the power to designate charities for charitable distributions from the trust. Another power might be the ability to borrow from the trust without adequate security, but this power will be appropriate only if the trust is likely to accumulate cash or cash-equivalent assets. The trust enforcer can be given the authority to remove the power later, and at that time the grantor trust treatment will end.

Initially, the owner gives a sum of money, for example, \$200,000, or some amount of company stock, to the trustee of the trust to create the trust. The trust then has sufficient assets to be able to get a small business administration loan, perhaps with the company as a co-borrower. If the company has a mission that appeals to impact investors, a social investment fund might be another source for a loan. The loan is used to finance the purchase of the stock.

The next step is the sale of the owner's shares of stock in the company to the trust, in exchange for a note, with market-rate interest. The note can provide for interest-only payments, with a balloon payment at the end of a term of years, or for payments of principal. The note and the trust document should permit the trustee to prepay the note without penalty. The sale to the trust will have no tax consequences because the owner is the grantor of the trust—the sale is from the owner to himself for tax purposes.

The owner will be taxed on the installment payments from the trust as the owner receives them. The proceeds of the loan can be used to make payments on the note, and because the trust owns the company stock, dividends paid to the trust can also be used to pay the installments. As the grantor of a grantor trust, the owner will include the trust income on the owner's individual tax return. Because the trust will use dividends it receives from the company to pay the installments, little taxable income should remain in the trust. The trust can include a nonmandatory provision to allow the trust to pay any tax owed by the owner as the result of the owner's being taxable on trust income.

After the note is paid, the trust enforcer will remove the grantor's power, thereby turning off the grantor trust status, and from that time forward, the trust will be treated as a separate taxpayer. The trust will own all the shares in the company, but profit from the company will be distributed to the trust only in amounts necessary to cover the administration costs in the trust. Other profit can be reserved for research and development, to make profit-sharing payments to employees, or for charitable contributions. Of course, the loan will need to be repaid, too.

If the grantor (the former owner of the company) dies before the note is repaid, any amount remaining on the note will be included in the owner's estate. It is unclear whether appreciation on the underlying assets will be included. The better outcome from a tax standpoint will occur if the note is paid before the grantor's death. For that reason, the founder of Edu Resources may decide to make a gift of half of the stock in the first year of the transition, so any estate tax on that half of the value of the company will be avoided. That is, even if the grantor dies with some amount of the note unpaid, half the value of the company will have been removed from the estate through the gift.

A stewardship trust cannot own shares in an S corporation, so many of the challenges associated with transitioning governance structure and discussed in this case study are unique to S corporations. If the stewardship trust is being created to take control of a C corporation or an LLC, the trust may own the company itself. Thus, many of the concerns associated with converting an S corporation into a stewardship trust, such as double taxation, will not be issues for those companies. However, other concerns and considerations face companies of any organizational structure, and each company planning to transition to ownership by a stewardship trust will have its own set of challenges. The next case study considers some of these other challenges.

### **Case Study #2: The Farm and Stewardship Trust Stakeholders**

The second case study involves a sustainable farm in Oregon considering the stewardship trust model for its method of governance. This farm is organized as an LLC and engages in both educational opportunities and conservation. Providing good lives and opportunities to its employees is also important to the farm's business model. Both owners of the farm hope to have a structure that will keep the company running effectively and in line with these purposes after they retire. The farm was designed to be mission driven, and its owners would like it to maintain its purposes even after they are not operating the farm. If the farm is to transition from being operated as an LLC owned by two individuals to an LLC owned by a stewardship trust, the owners will face challenges like selecting the right people to act as trustees, trust enforcers, and stewardship committee members. Selecting parties that have a connection to the farm is a way to keep these parties accountable to the trust's purpose, but identifying these parties may be difficult at first.

The farm might use a bank as a trustee for the stewardship trust. A corporate trustee would handle minimal administrative duties yet would not become overinvolved in the functioning of the business as an LLC. Using a bank is a good option for many companies that want the trustee to have little interference in the governance of the business. Further, the stewardship trust is a type of directed trust, so the duties of the trustee of a stewardship trust are relatively light in comparison to trusts in which trustees manage everything. Because of this focus on basic administrative duties instead of a role in actively managing the assets held in trust (i.e., the company), a bank would make an excellent trustee. Still, there are other options for the choice of trustee. For example, a company may wish to use a professional fiduciary instead. An individual trustee might be possible, but given the perpetual nature of a stewardship trust, successors would have to be carefully considered.

A stewardship trust requires a trust enforcer who will keep informed about the business operations without serving as a director of the company or as a trustee of the trust. The enforcer provides oversight but is not involved in running the business. The trust enforcer makes sure the purpose of the trust—running the business as intended by the founders—continues to be carried out and can intervene to get the trust back on track if too much mission drift occurs. For the farm's stewardship trust, an organization with a similar purpose would be a great enforcer. The farm is dedicated to land conservation, so a nonprofit organization like a land conservancy trust could be a good choice as enforcer for the farm. A land conservancy trust manages land conservation easements, a purpose different from that of the farm, but the land conservancy shares a dedication to conservation. A trust enforcer could even be a stewardship trust with a purpose similar to that of the company, although there are not enough stewardship trusts in existence at this point for this to be a realistic option. The stewardship trust structure requires at least one trust enforcer but allows for additional trust enforcers, if desirable for a particular trust.

The stewardship committee must comprise at least three people, all of whom act as fiduciaries for the stewardship trust. Or. Rev. Stat. § 130.190(4). The committee directs many of the actions of the trustee, in particular decisions with respect to the business, and the trust operates as a directed trust. Although

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the duties of committee members are not necessarily the same as being on a corporate board, many of the duties and responsibilities are shared between both governance structure models. Committee members should thus be individuals the trust creator believes will act effectively as fiduciaries for the trust. In the case of many family businesses, a child who would like to be involved with his parents' business but not run it entirely would be an effective committee member.

For an organization dedicated to its employees, as the farm is, the stewardship trust committee could include employees who would ensure that their interests as stakeholders within the organization are not compromised after the organization becomes a trust. The farm would always like to pay its employees living wages, alongside other benefits like paid time off. One or more employees serving on the stewardship committee can represent these interests. The stewardship committee may also have individuals representing organizations that are close partners to the trust, ensuring that these close partners do not have their interests in working with the trust severed after the change in structure. For example, if the farm has a nonprofit that operates alongside it yet will not become part of the trust, one spot on the stewardship committee could be reserved for someone serving as a director of the nonprofit. Thus, stewardship committee members should represent a wide variety of stakeholder interests so that the business is effectively administered.

Like the owner of the educational resources company in the first case study, the farm owners will face some challenges in preserving the business part of the farm while the trust property is being transferred. The farm owners want to retire more quickly than the owner of Edu Resources, however, so making gifts and sales over several years is not an effective method of transferring their property interests into the trust. The farm owners will have to determine the best way to transfer the LLC to the trust in a short amount of time. The transfer could be accomplished by having the trust acquire a social finance loan so that it can pay for shares of the LLC. Alternatively, or in addition, the trust could issue and sell nonvoting stock to parties interested in the organization's purpose, such as impact investors. Some companies may have enough cash on hand or other cash streams to finance the transition into the stewardship trust form, without needing to obtain a loan or issue stock, but most businesses will need some additional source of financing. With the variety of the organizations that could adopt the stewardship trust model, business owners and estate planners should be aware of the numerous tools available for the transition process.

Another way the farm differs from Edu Resources is that the farm owners are more concerned with solidifying the farm's purpose and keeping its missions in place than with future profit generated by the farm. The farm owners have considered other options instead of the stewardship trust, such as using an ESOP model, because of the priority they place on the continuing welfare of their employees. But the owners find the way the stewardship trust preserves a business's noneconomic purposes to be important and appealing. Because the income generated from the farm, such as from the sale of milk and cheese, is not a significant revenue source, the farm does not have to worry about the taxation of income in the trust. The trust is an appealing structure for ownership of the farm to use because the restrictive structure will preserve the mission over time. Although economic benefits can always be a factor, the noneconomic benefits of a stewardship trust may be the driving reason some businesses will choose to use this form.

These two case studies raise some of the issues a business owner will consider when contemplating transition to a stewardship trust as the governance structure for their business. Challenges exist, but for a business owner who wants to protect the business's purposes, including noneconomic purposes, into the future, a stewardship trust may be a good option. The Oregon statute provides the broad outlines of the structure of such a trust, as well as default rules for operation of the trust, so an Oregon stewardship trust may be useful even for a business operating in another state.