

Table of Contents

	<u>Page</u>
Part I. The Historical Context and Current Developments.....	5
A. General.....	5
B. The Total Return Concept – Developments in Corporate Law in the 1960s and 1970s.....	8
1. The Law and the Lore of Endowment.....	11
2. UMIFA – Embracing the Total Return Concept.....	13
3. Expenditure of Endowment Fund Assets .....	14
4. Investment Management and Delegation.....	19
5. The Adoption of UMIFA by the States.....	19
C. The Modernization of the Trust Law – The 1980s and 1990s. ....	21
1. Uniform Prudent Investor Act .....	22
2. Uniform Principal and Income Act of 1997: Trust Law's Long-Awaited Modernization.....	24
3. Adoption of the Act by the States – Equitable Adjustment and Unitrust Conversion .....	28
D. Revisions to UMIFA – The Demise of Historic Dollar Value? – Developments in the 21 <sup>st</sup> Century.....	28
1. Charitable Trusts.....	29
2. The Demise of Historic Dollar Value? .....	30
3. Conformity in Standard of Care .....	32
E. Other Legal, Non-Statutory Constraints.....	33
1. Socially Responsible Investing.....	34
2. Public Benefit. ....	37
F. Legal Constraints—Conclusion.....	41
Part II. FASB Accounting Rules .....	42
A. General.....	42
B. SFAS No. 116 – Accounting for Contributions Made and Contributions Received .....	45

Table of Contents  
(continued)

	<u>Page</u>
C. SFAS No. 117 – Financial Statements of Not-for-Profit Organizations .....	48
D. SFAS No. 124 – Accounting for Certain Investments Held by Not-for-Profit Organizations.....	50
E. SFAS No. 136 – Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others .....	51
1. Accounting for Assets Among Recipients and Beneficiaries.....	52
2. Accounting for Transfers Between Resource Providers and Recipients.....	53
Part III. Limitations in Accounting Standards and Interaction between Accounting Standards and Statutory Rules .....	54
A. Entity v. Fund-by-Fund Reporting .....	56
B. Interaction Between Statutory Rules and FASB .....	58
1. Interactions Between State Statutory Rules and FASB.....	58
2. When UMIFA Leaves Things to the Discretion of the Board.....	62
C. SFAS No. 124 – "Permanently Restricted" Assets; Treatment of Losses .....	63
D. SFAS No. 136 – Accounting for Assets Amongst Affiliated Organizations .....	66
Part IV. Conclusions and Where Are We. ....	67

**DRAFT**  
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**CHARITABLE ASSET MAINTENANCE:  
Flexibility and Responsibility in the Not-for-Profit Arena**

**by**

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## Introduction

Not-for-profit organizations in the United States serve an important role in establishing and assisting society's cultural, social service, health, educational and artistic institutions. Although from the outside, these organizations may appear similar to non-charitable, or private, organizations in many ways, certain basic components of their operation and management, and the resulting legal constraints on their activities, sharply differ from for-profit organizations. One primary distinction between private and not-for-profit organizations relates to the mechanisms by which their activities are scrutinized. In the for-profit corporate context, shareholders, as a result of their financial investment, can serve as a check on both the management and the boards of directors of for-profit organizations. Further, in the private trust context, private beneficiaries of either the income or the remainderman interest have a direct interest in monitoring the trustee's activities.<sup>1</sup>

This is not the case for not-for-profit organizations. Unlike for-profit corporations, not-for-profit corporations are not owned by private individuals.<sup>2</sup> Further, charitable trusts have no private beneficiaries. In the absence of an institutional supervisory mechanism, the role of a charitable organization's board of directors or trustees is paramount.<sup>3</sup> A board of directors is responsible for the organization's operations within the parameters of the legal rules to which the organization is subject, and individual members of boards of directors may be personally liable for organizational mismanagement. Given this context, it is crucial that boards of directors understand the legal rules and have adequate access to information about the organization's assets and activities in order to ensure compliance. This is not necessarily an easy feat, particularly in

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<sup>1</sup> As stated by Professor Karst several decades ago, the law "generally relies on those who are most immediately interested in the property or enterprise administered by a fiduciary to call ... enforcement machinery into action." Kenneth L. Karst, "The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility," 73 Harv. L. Rev. 433, 436 (January 1960).

<sup>2</sup> It is true that many not-for-profit organizations are membership organizations and members of those organizations are in some ways analogous to shareholders. However, unlike a shareholder, a member of an organization does not have an ownership interest in that organization; her/his own personal wealth does not rise and fall in relation to the success of the organization.

<sup>3</sup> This paper will use the terms "board of directors" and "board of trustees" interchangeably.

the context of large organizations with complex activities and asset holdings. A primary tool boards of directors use in understanding the assets and activities of an organization is the organization's annual accounting statements. However, the primary purpose of financial statements is not to serve as an internal mechanism to teach board directors about the organization. Rather, the financial statements serve primarily to educate donors, members and creditors. The statements are in fact the *responsibility* of the board and are not designed to educate the board.

The interplay between the legal constraints on a not-for-profit organization's activities, the board of directors' role in assuring the organization operates within the parameters of these constraints, and the access of board members to comprehensive and comprehensible information about the organization are particularly evident when it comes to the management of charitable assets held by the organization. The legal rules governing a not-for profit organization's handling and preservation of its charitable assets are imposed by the laws of the individual state in which that organization was formed and may also be imposed by the laws of the state in which those assets are held and the organization operates. These laws range from general standards of care imposed on the governing board of the organization to more specific rules regarding the expenditure of charitable assets.

When assets are contributed to a charity as "endowment funds," meaning that they are contributed subject to donor restrictions as to their expenditure, state law generally imposes specific restrictions on the charity's ability to invest and spend such assets. The primary restrictions that have generated considerable confusion in the not-for-profit community are the proper limits on an organization's ability to invest charitable assets, to delegate responsibility for the investment of its assets, and to spend the return on those investments.

Boards of directors now generally understand their duty to maximize the return on the investment assets held by not-for-profit organizations, both to support current operations and to ensure their organizations' futures to carry on their missions. There is for the most part an acceptance of modern portfolio theory with its emphasis on a diversified portfolio, and allocation of investments assets among different types of

investments. The natural corollary of modern portfolio theory is the adoption of a "spend rate" for an organization, a percentage -- generally ranging from three to seven percent-- of the rolling average of the value of the organization's investment assets over a period of time, say the last twelve to twenty quarters, in order to smooth out bumps and blips in value.<sup>4</sup> The resulting amount is drawn down annually to cover current operations of the organization, and the aim is generally that the return on the organization's assets, after the annual draw down, will at least equal inflation, so as to protect the purchase power of the organization.

This practice and acceptance of the total return concept is a development primarily of the last thirty years, sanctioned for not-for-profit corporations with the adoption of the Uniform Management of Institutional Funds Act ("UMIFA"), which has been adopted in one form or another in most states. Despite its acceptance, however, boards of directors face a panoply of issues in their investment and expenditure practices, particularly when dealing with endowment funds and the state laws governing their management and maintenance and often do not have access to sufficient information concerning the organization's endowment funds. Although endowment funds are reflected on an organization's financial statements, they are not necessarily reflected in a manner that is most useful to a board director in its endeavoring to comply with endowment fund maintenance rules.

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This paper discusses the legal rules and the accounting standards applicable to the investment and handling of the endowment fund assets of not-for-profit organizations. The paper endeavors to provide a historical context for these rules and standards and points out areas where the rules hinder the efficient management of not-for-profit organizations, or where the legal rules on the one hand and the accounting rules on the other are not completely harmonized. Moreover, it attempts to point out the need for an

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<sup>4</sup> Most organizations use fair market value in calculating the rolling average, although some use the assets' book value. See Joel C. Dobris, "Real Return, Modern Portfolio Theory, and College, University and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules," 28 Real Prop., Prob., & Trust J. 49, 63 (1993).

organization's board of directors, and financial officers, to be properly educated about the legal constraints which they face, and the need to scrutinize and understand the organization's financial statements.

Part I discusses the historical context out of which the legal rules applicable to charitable asset maintenance emerges. Primarily, it looks at the development of the standard of care imposed on fiduciaries and the restraints on their ability to invest and manage assets from its genesis in the private trust law area. While this paper generally focuses on the rules applicable to not-for-profit corporations (rather than charitable trusts), this section on the history of developments in the standard of care has been organized chronologically because the developments in trust law and not-for-profit corporate law have a curious history and have leap-frogged one another. This part also explores the non-statutory constraints on investment of charitable funds.

Part II of this paper turns from legal rules to accounting rules. This section summarizes the standard accounting rules applicable to charitable organizations promulgated by the Financial Accounting Standards Board ("FASB"). Part III discusses the interaction of the legal and accounting rules. It focuses on several aspects of the accounting rules that are at somewhat cross purposes with the legal constraints on charitable organizations and consequently may not serve to provide an accurate snapshot of a charitable organization's available assets. This section also discusses some of the areas in which the accounting rules are subject to interpretation, thus impeding the goal of standard disclosure across all charitable organizations.

Finally, Part IV endeavors to sum up where we are now and raises some issues for consideration, including suggesting a potential mechanism for ensuring board of director awareness of an organizations' endowment funds that does not rely on the organization's financial statements.

## **Part I. The Historical Context and Current Developments.**

### **A. General.**

The laws governing the investment activities of not-for-profit organizations derive from the laws governing trusts. The notion that a fiduciary is subject to legal restrictions on its management of assets held in trust is one with deep roots in English common law.<sup>5</sup> This law often imposed very formalistic restrictions on the ability of fiduciaries to invest trust assets. In fact, the English Court of Chancery published a list of acceptable assets in which trustees could invest charitable assets, principally comprised of government securities.<sup>6</sup> In the background of this inflexible regime was a general understanding that investments in other than fixed income securities such as government bonds was “speculation,” and to be avoided.

In the United States, however, there was a much more limited pool of governmental securities available and those assets were not necessarily safe investments. Some trustees invested trust assets in assets other than debt securities, including equity investments. In reviewing whether a trustee had breached its fiduciary duty with respect to a trust that suffered a significant loss in value due to the decline in value in its equity investments, the Massachusetts Supreme Judicial Court noted in 1830 the fallacy in thinking that some investments were inherently safe and others inherently unsafe.<sup>7</sup> Uttering its famous statement regarding the inherent risk involved in investment, “[d]o what you will, the capital is at hazard,” the Court announced a new standard of care applicable to investment of trust assets, the “prudent man” standard. As the court articulated this standard:

All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering

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<sup>5</sup> Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule*, p. 11 (Oxford 1986).

<sup>6</sup> *Id.*

<sup>7</sup> *Harvard College and Mass. Gen. Hosp. v. Francis Amory*, 26 Mass. (9 Pick) 446, 469 (1830).



the probable income, as well as the probable safety of the capital to be invested.<sup>8</sup>

As described by Bevis Longstreth, this standard did not gain wide acceptance outside of Massachusetts until the 1940s.<sup>9</sup> Many states in fact promulgated lists of acceptable investments, primarily fixed-income securities, similar to the lists of the English Court of Chancery.<sup>10</sup> The New York Court of Appeals, in fact, announced in an 1869 decision, *King v. Talbot*, that common stock investments were inherently imprudent.<sup>11</sup>

As Longstreth describes it, in part in the wake of the collapse of the bond market in the 1940s, states began to move toward adopting a more flexible approach to the investment management of trust assets, codifying prudent man standards. Further, in 1942 the American Bankers Association promulgated the Model Prudent Man Investment Act, which adopted as its standard of care the standard adopted by the Massachusetts Supreme Court in 1830 in *Harvard v. Amory*.<sup>12</sup>

Despite the flexibility of the language of the prudent man standard, fiduciaries with respect to trust assets nonetheless were constrained in their investment activities as a result of interpretations of the standard by commentators. As Longstreth argues, it is primarily the interpretation of the standard in two authoritative texts in the private trust arena, the 1959 Restatement (Second) of Trusts and A.W. Scott's influential treatise, *Law of Trusts*,<sup>13</sup> which dramatically reduced the flexibility in the rule. These texts changed the standard from that of the prudent man, which charged the trustee with the duty to treat trust property as s/he would treat her/his own property to the “prudent trustee,” who uses “the caution in making investments which is used by prudent men who have primarily in view the preservation of their property, of men who are safeguarding property for others.”<sup>14</sup> Further, these treatises tended to prioritize conservative investments, even if the return on

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<sup>8</sup> *Id.*

<sup>9</sup> Longstreth, *Modern Investment Management and the Prudent Man Rule* at p. 12.

<sup>10</sup> See, e.g., N.Y. Pers. Prop. Law §21(1).

<sup>11</sup> 40 NY 76 at 87-90 (1869).

<sup>12</sup> Longstreth, *Modern Investment Management and the Prudent Man Rule* at p. 13. In 1969, the Uniform Probate Code § 7-302, in 1972, UMIFA, and in 1974 the Employee Retirement Income Security Act, also adopted versions of the prudent man standard.

<sup>13</sup> A.W. Scott, *Law of Trusts* (3d ed. 1967).

<sup>14</sup> Scott, *Law of Trusts*, § 227.3.

those investments resulted in diminishing the original purchasing power of the trust. Finally, both texts spoke against speculation and set up categories of permissible and generally impermissible investments.<sup>15</sup> As applied by courts in various states, a strong emphasis was placed on avoiding speculation.<sup>16</sup>

By focusing so singularly on specific investments that were speculative, these treatises discouraged consideration of overall investment performance. Specific investments can always depreciate. Today, holding an investment manager accountable for the decrease in value of a single investment within a large investment portfolio would be unusual, particularly if the portfolio as a whole enjoys appreciation. Nonetheless, the singular focus in the commentary on the investment results of each particular investment discouraged trustees from purchasing other than very conservative securities.<sup>17</sup>

Under the influence of the *Restatement* and the *Law of Trusts*, trustees were extremely constrained in their management of trust assets and were unable to invest assets in accordance with modern investment practices. As early as 1934, in an influential treatise in the field of economics, Professors Graham and Dodd noted the fallacy of the typical bifurcation of investments into those that are and are not speculative.<sup>18</sup> In fact, the typical modern investment portfolio combines a range of assets in terms of their level of investment risk.<sup>19</sup>

Finally, as the number of available investment options increases, and as expertise in specific areas of investments becomes more specialized, modern investment practice typically involves a certain amount of delegation of investment activities to those with

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<sup>15</sup> The 1959 Restatement (Second), for example, states that the purchase of shares of stock on margin or bonds selling at a discount due to uncertainty as to whether they would pay on maturity is speculative and imprudent. Restatement (Second) of Trusts § 227 cmt. f. Additionally, junior mortgages were considered in some jurisdictions to be imprudent, as were investments in “new and untried enterprises.”

<sup>16</sup> John H. Langbein, “The Uniform Prudent Investor Act and the Future of Trust Investing,” 81 Iowa L. Rev. 641, 644 (March 1996).

<sup>17</sup> See Evelyn Brody, “The Limits on Charity Fiduciary Law,” 57 Md. L. Rev. 1400 (1988).

<sup>18</sup> See Benjamin Graham & David L. Dodd, *Security Analysis* (McGraw Hill 1934), as cited in Longstreth, *Modern Investment Management and the Prudent Man Rule* at p. 87. Longstreth points out that despite the influence of this treatise within the economics community, there was typically little dialogue between the legal and the economics communities and so the drafters of the Restatement one year later may not have been aware of the issues raised in Graham & Dodd’s treatise. *Id.*

<sup>19</sup> Modern investment practices frequently incorporate equity along with other more recent forms of investment assets, such as derivatives and hedging transactions. Additionally, it is not at all uncommon in modern investment practice to purchase securities on margin.

necessary expertise. However, private trust law generally prohibited trustees from delegating any of their activities in managing trust assets. If the trustee could reasonably be required to personally perform a specific act, that act could not be delegated.<sup>20</sup> Professor Langbein suggests that the rationale for this rule is “murky” and may stem from the settlor of the trust’s personal reliance on the personality of the trustee.<sup>21</sup>

It was clear to many that the prudent man standard was a failure in application. Commentators urged that the standard of care applicable to trustees requires a focus on the careful and deliberate process of the trustee in managing trust assets, rather than on the success or failure of specific investment assets chosen by that trustee.<sup>22</sup> As Longstreth stated in 1986, although hailed as “a bright star in a newly discovered galaxy,” the prudent man standard as it has been interpreted, “ha[s] made a black hole the more likely metaphor.”<sup>23</sup>

## **B. The Total Return Concept – Developments in Corporate Law in the 1960s and 1970s.**

Given this background of trust law, most endowments of not-for-profit organizations were primarily invested in fixed income securities, such as bonds, which provided a dependable income stream, but which provided meager overall returns.<sup>24</sup> The need for current income often outweighed the long-term interest in growth. This practice, however, not only precluded maximum growth, but also “allow[ed] the value of the underlying endowment assets to be eroded by inflation over time.”<sup>25</sup>

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<sup>20</sup> See Restatement (Second) of Trusts § 171.

<sup>21</sup> Langbein, “The Uniform Prudent Investor Act and the Future of Trust Investing,” 81 Iowa L. Rev. at 650; see also Langbein, “Reversing the Nondelegation Rule of Trust Investment Law,” 59 Mo. L. Rev. 105, 106-110 (1994).

<sup>22</sup> Longstreth, *Modern Investment Management and the Prudent Man Rule* at 152-153.

<sup>23</sup> *Id.* at p. 13.

<sup>24</sup> Mary Shmid Daugherty, *Uniform Management of Institutional Funds Act – the Implications for Private College Board of Regents*, 57 WEST’S ED. LAW REP. 319, n.3 (1990).

<sup>25</sup> Terry L. Simmons, *The Uniform Management of Institutional Funds Act and Its Meaning for Colleges and Universities*, AGB PUBLIC POLICY PAPER SERIES at 2.

This pattern of conservative investing persisted into the mid 1960s.<sup>26</sup> However, at that point, due to changing market conditions, managers of endowment funds at educational institutions began to question the wisdom of the currently prevailing investment practices. While earlier in the decade, inflation was low and college enrollment "historically high,"<sup>27</sup> in the late 1960s enrollment slowed, inflation rose, and, as interest rates went up, outstanding bond values declined.<sup>28</sup> Throughout the sixties, however, the overall value of investments in equity securities had increased sharply.<sup>29</sup> While most funds were suffering, as a result of their substantial holdings in bonds, those institutions that had a greater portion of their investments in stocks benefited considerably.<sup>30</sup>

The temptation—even the need—to alter investment strategies to increase investment holdings in stock faced several obstacles. The root of this difficulty was the fact that it was believed that endowment spending should be managed consistent with traditional private trust law, spending only income and leaving the principal untouched.<sup>31</sup> As income was defined under private trust law principles, it included items such as interest and dividends, but did not include appreciation, realized or unrealized, on investment assets.<sup>32</sup> Capital gains were generally considered part of principal and were required to be retained for the trust remainderman.<sup>33</sup> A shift toward greater overall holdings in equity would have the benefit of increasing overall appreciation on fund assets, but that appreciation could not be spent under traditional trust law principles—only the dividend income on those securities could be spent. And since at that time dividend rates were lower than the rate of return on bonds, the shift to greater overall holdings in stocks

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<sup>26</sup> Douglas M. Salaway, Note, *UMIFA and a Model for Endowment Investing*, 22. J.C. & U.L. 1045, 1054 (1996).

<sup>27</sup> Daugherty, *supra* note 24 at 319.

<sup>28</sup> *Id.* at n.3. It was during this period that governing boards needed to rely more on their endowment funds. *Id.* at 319.

<sup>29</sup> See William L. Cary & Craig B. Bright, *The Law and the Lore of Endowment Funds*, Report to the Ford Foundation at p. 5 (1969) ("*The Law and the Lore*") (during the 1960s, the average price of common stocks rose seven times as fast as the cost of living).

<sup>30</sup> Simmons, *supra* note 25 at 4.

<sup>31</sup> Salaway, *supra* note 26, at 1054

<sup>32</sup> Cary & Bright, *The Law and the Lore* at p. 13.

<sup>33</sup> *Id.*

would put organizations in a worse position than they were already in, in meeting operating expenses.<sup>34</sup>

Witnessing the greater overall return they could potentially enjoy through holding stocks, yet recognizing the need for current income, many colleges shifted their focus to a total return investment strategy, questioning the applicability of private trust law principles to charitable asset maintenance.<sup>35</sup> The total return strategy, in which "both yield and capital appreciation are treated as income, less an amount that must be reinvested to compensate for inflation," would provide the flexibility needed to maximize the value of endowments.<sup>36</sup> External pressure also fueled interest in a total return investment strategy as a result of widespread press coverage of the dwindling value of funds at several major institutions.<sup>37</sup> As one author explained, "[t]he negative press was disconcerting for both the development office responsible for the fund raising and the governing board responsible for managing funds. It was obvious that these funds needed more active management and/or new investment policy."<sup>38</sup>

Some educational institutions maintained a policy that appreciation could be expended. Harvard University, for example, took this approach with respect to its considerable endowment appreciation, drawing the attention of other institutions.<sup>39</sup> However, there was doubt about the legality of this approach, and organizations concerned with liability continued, and were advised, to maintain their policy of

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<sup>34</sup> Salaway, *supra* note 26, at 1055.

<sup>35</sup> William L. Cary & Craig G. Bright, *The Developing Law of Endowment Funds: "The Law and the Lore" Revisited*, A Report to the Ford Foundation at pp. 9-10 (1974) ("*The Law and the Lore (Revisited)*"); Salaway, *supra* note 26, at 1055.

<sup>36</sup> UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT, Prefatory Note, 7A U.L.A. 475, 476 (1999). Several different kinds of spend rates have been adopted by charitable organizations. Organizations vary in the percentage of the value of their assets that may be drawn-down for expenditure and in the number of months over which the organization determines the average value of the assets. Further, some organizations adopt a policy that allows for fluctuations in the percentage draw-down, but subject to a cap. Additionally, some organizations have adopted complex formulas where the percentage of assets that may be spent in any year shifts in relation to asset performance within a time period. See Joel Dobris, "Real Return, Modern Portfolio Theory, and College, University and Foundation Decision on Annual Spending from Endowments: A Visit to the World of Spending Rules," *supra* note 4 at 65.

<sup>37</sup> Daugherty, *supra* note 24, at 320.

<sup>38</sup> *Id.*

<sup>39</sup> Simmons, *supra* note 25 at 2.

expending only income, and thus were forced to invest conservatively in current income-producing assets.<sup>40</sup>

There was a surprising lack of legal authority in this area to guide fund managers and trustees.<sup>41</sup> Nonprofit and general corporate statutes did not address the investment of and ability to expend endowment funds. Further, there was uncertainty as to whether different rules should apply to charitable assets held in trust on the one hand and held in corporate form on the other. In practice, charitable trusts were often more frequently the subject of litigation, courts tending to be more likely to apply trust law principles to charitable entities organized in trust form.<sup>42</sup> Calling for a law specific to charities, in 1960 Professor Kenneth Karst pointed out the illogic in treating charitable trusts and corporations differently merely based on their form.<sup>43</sup> Karst stated that there was "no good reason for making different rules for the managers of two large foundations simply because one is a corporation and the other a trust. The law should recognize that the charitable trust and the charitable corporation have more in common with each other than either has with its private counterpart."<sup>44</sup> Despite Karst's plea, it would be more than a decade before any development of a law applicable to charities, and another thirty years before the development of the law explicitly applicable to charitable trusts.<sup>45</sup>

#### 1. The Law and the Lore of Endowment

Fueled by the inefficiency of the then-prevailing approach to investment and accounting by colleges and universities, in the late 1960s, the Ford Foundation commissioned William Cary and Craig Bright to examine whether total return investing

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<sup>40</sup> *Id.* See also Unif. Mgmt. of Institutional Funds Act, Prefatory Note, 7A U.L.A. at 476. Kenneth Karst points out that unlike the beneficiaries of a trust or shareholders in a corporation, charities have "no beneficiary in a comparable position who is sufficiently interested as an individual to call the charitable fiduciary to account." Karst, "The Efficiency of the Charitable Dollar," *supra* note 1 at 436. Though Karst was discussing the enforcement of laws governing charitable fiduciaries, this lack of enforcement also suggests a lack of pressure to maximize return, perhaps explaining why conservative, inefficient investment trends persisted for so long.

<sup>41</sup> As the Prefatory Note to UMIFA states, "[t]here is virtually no statutory law regarding trustees or governing boards of eleemosynary institutions, and case law is sparse." 7A U.L.A. at 477.

<sup>42</sup> See Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule* at p. 23.

<sup>43</sup> Kenneth Karst, "The Efficiency of the Charitable Dollar," *supra* note 1 at 436.

<sup>44</sup> *Id.*

<sup>45</sup> However, as discussed below, equal treatment of charitable trusts and charitable corporations has not yet been achieved.

could be adopted by educational institutions.<sup>46</sup> Their seminal study concluded that it could, and that colleges and universities were “giving up capital gain returns because of mistaken definitions of prudence and a desire not to lock up capital gain in perpetuity in endowments.”<sup>47</sup> As suggested by the title of their report, Cary and Bright found that “legal impediments which have been thought to deprive managers of their freedom of action appear on analysis to be more legendary than real.”<sup>48</sup>

Cary and Bright questioned the applicability of state private trust law to educational organizations. First, they noted that there was no specific law requiring the application of private trust law in the charitable context, stating, “[w]e find no authoritative support in the law for the widely held view that the realized gains of endowment funds can never be spent.”<sup>49</sup>

But in addition to the fact that there was no law requiring the application of private law principles, Cary and Bright argued that such principles were not logically consistent in the charitable context.<sup>50</sup> First, unlike in the private trust law context, there is no adversity between the income beneficiary and the remainderman in the charitable endowment fund context. While the fiduciary of a charitable endowment is responsible for maintaining the fund in perpetuity, it is not required to strike a balance between two adverse parties.

Cary and Bright also pointed out that the definition of “income” in contexts other than private trust law did not exclude appreciation. For example, statutes defining corporate income or its accumulation “invariably encompass realized appreciation within the scope of their definition.”<sup>51</sup> Further, the Haig-Simons concept of income, which was the then-prevailing economic concept of income, would include all measurable

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<sup>46</sup> Cary and Bright, *The Law and the Lore*.

<sup>47</sup> Joel C. Dobris, “Real Return, Modern Portfolio Theory, and College, University, and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules,” *supra* note 4 at 52.

<sup>48</sup> Cary and Bright, *The Law and the Lore* at p. 66.

<sup>49</sup> *Id.*

<sup>50</sup> Note that even prior to Cary and Bright, there was an acknowledgment that the then-prevalent lists of permissible investments for private law trustees should not apply to trustees of charitable corporations. See Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule* at p. 24 (citing, Restatement (Second) of Trusts § 389 comment b).

<sup>51</sup> Cary and Bright, *The Law and the Lore* at p. 27.

appreciation in income.<sup>52</sup> Although by operation of the income tax law -- a realization-based system of taxation -- there is generally a sharp distinction between realizing appreciation and leaving it unrealized, Cary and Bright pointed out that such distinction is not as significant for tax-exempt organizations.<sup>53</sup>

Cary and Bright urged states to develop laws applicable to educational organizations that would permit modern investment strategies and practices. They concluded their study:

Anglo-American law has never stood for long in the path of progress, but has accommodated to changing needs. This is and should be its role and function in the field of education.<sup>54</sup>

## 2. UMIFA – Embracing the Total Return Concept

In the early 1970s, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") set out to promulgate a uniform code in order to permit institutions holding endowment funds to invest in long-term growth investment assets, yet, at the same time, have funds available for expenditure on a current basis. In 1972, they promulgated UMIFA to address these concerns as well as others in the area of endowment fund maintenance. Although the focus of Cary and Bright's study, *The Law and the Lore*, was the particular problem facing educational institutions holding endowments, drafters of UMIFA realized that "the problems were not unique to educational institutions but were faced by any charitable, religious or any other eleemosynary institution which owned a fund to be invested."<sup>55</sup> As a result, UMIFA applies to funds held by an "incorporated or unincorporated organization organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes, or a governmental organization to the extent it holds funds exclusively for any of these purposes," provided that such funds are held by the institution for its "exclusive use, benefit or purposes."<sup>56</sup> Given this broad definition,

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<sup>52</sup> *Id.* at p. 28-29.

<sup>53</sup> *Id.* at pp. 34-35.

<sup>54</sup> *Id.* at p. 66.

<sup>55</sup> UMIFA, Prefatory Note, 7A U.L.A. at 477.

<sup>56</sup> UMIFA §1(1), 1(2).



UMIFA applies generally to colleges, universities, hospitals, religious organizations and other institutions of an eleemosynary nature.<sup>57</sup>

By its own terms, UMIFA does not apply to funds held for a charitable institution by a trustee that is not a charitable institution (e.g., a community foundation in which a bank or other financial institution acts as a trustee) or a fund in which a non-charitable beneficiary has an interest (such as a split interest charitable lead or remainder trust).<sup>58</sup> UMIFA does not preclude its applicability to charitable trusts generally, but it does not clearly state that it does apply to charitable trusts. Further, many states that have adopted UMIFA have limited its applicability to state not-for-profit corporations.<sup>59</sup>

### 3. Expenditure of Endowment Fund Assets

The operative provision of UMIFA that enables an organization to adopt total return spending policy is Section 2, "Appropriation of Appreciation." It states that:

The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent ....<sup>60</sup>

Under this provision, an organization is authorized to spend amounts relating to the appreciation on endowment fund assets. The appreciation may be spent even if such amounts are not realized, including when all or part of the endowment fund is invested in long-term growth securities. The organization, in other words, need not feel constrained

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<sup>57</sup> See Comment to Section 1 of UMIFA, 7A U.L.A.

<sup>58</sup> See Comment to Section 1 of UMIFA. For example, where the trustee is a bank or trust company holding funds for the sole benefit of an organization, UMIFA does not apply. *Id.* UMIFA also does not apply to "a fund in which a beneficiary that is not an institution has an interest, other than possible rights that could arise upon violation or failure of the purposes of the fund." *Id.*

<sup>59</sup> See, e.g., New York N-PCL. However, Connecticut, Hawaii, Indiana, North Carolina, Virginia and West Virginia have adopted UMIFA-based statutes applicable to community foundations organized in trust form. Jane L. Wilton, "Endowment Funds of Not-for-Profit Corporations," *Professional Tax and Estate Planning Notes*, (October 2003). The rules generally governing the maintenance of endowment funds held by charitable trusts are found in state trust laws, including the versions of the Uniform Principal and Income Act adopted in various states.

<sup>60</sup> UMIFA §2.

to spend only the income (such as interest, dividends, rents or royalties) generated from the investment assets.<sup>61</sup>

An "endowment fund" is defined under UMIFA as "an institutional fund, or any part thereof, not wholly expendable by the institution on a current basis under the terms of the applicable gift instrument."<sup>62</sup> Thus, Section 2 only applies to "donor-restricted" funds and does not apply to funds wholly expendable by the institution, but which the institution elects to restrict as to their expenditure.<sup>63</sup> Nor does Section 2 apply to funds held by an institution that are restricted merely as to their use. For example, a donation to a charitable institution organized for the protection of the environment where the applicable gift instrument requires that the funds be used solely for preservation within a designated geographic region is not an endowment fund within the meaning of UMIFA merely because of the use-related restriction. By contrast, if the gift required that the original gift amount be preserved and retained by the organization, the gift would create an endowment fund within the meaning of UMIFA.<sup>64</sup>

Important to the operation of Section 2 of UMIFA is the concept of "historic dollar value." This is defined in UMIFA as:

the aggregate fair value in dollars of (i) an endowment fund at the time it became an endowment fund, (ii) each subsequent donation to the fund at the time it is made, and (iii) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the fund. The determination of historic dollar value made in good faith by the institution is conclusive.<sup>65</sup>

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<sup>61</sup> UMIFA does not restrict the expenditure of a fund's income under any circumstances. Thus, even if a fund has dropped below its historic dollar value due to depreciation of the assets in which the fund is invested, the income generated by those assets are not restricted from expenditure under UMIFA.

<sup>62</sup> UMIFA §1(3).

<sup>63</sup> Such funds are often called "quasi-endowment funds" or "funds functioning as endowment." There is a substantial amount of confusion in many organizations about the funds to which UMIFA applies. The concept of "quasi endowment" may not be understood and because many organizations hold their endowment funds, quasi-endowment funds and unrestricted operating funds in a general investment pool, their officers and boards may not understand which of these funds are subject to UMIFA.

<sup>64</sup> The term "gift instrument" under UMIFA means "a will, deed, grant, conveyance, agreement, memorandum, writing, or other governing document (including the terms of any institutional solicitation from which an institutional fund resulted) under which property is transferred to or held by an institution as an institutional fund." UMIFA §1(6).

<sup>65</sup> UMIFA §1(5).

Under this definition, the historic dollar value of a gift is generally the fair market value of the gift at the time it is made. For example, the historic dollar value of a \$1,000 donation to an organization in order to create an endowment fund will be \$1,000. If the donor makes a subsequent donation to that fund in the amount of, say, \$1,000, the historic dollar value of the fund will be \$2,000 (\$1,000 plus \$1,000). Further, if a gift instrument directs accumulation, historic dollar value will increase with respect to such accumulation. In other words, if, for example, a donor makes a \$1,000 gift to an institution and directs that the fund should be accumulated until its value reaches \$1,500, the historic dollar value will increase from \$1,000 to \$1,500.

Other than pursuant to these specific rules, historic dollar value does not change. Historic dollar value is not reduced as a fund incurs expenses, nor is it increased as the fund value increases, even if the organization decides to retain fund appreciation for any number of reasons, including to retain the original purchase power of the fund.<sup>66</sup>

Note that a donor could make a gift to a charitable organization that is only partially an endowment fund. For example, if a donor makes a grant of \$1,000 for use for a specific purpose with the direction that \$500 of such gift be retained in perpetuity, then \$500 of such gift creates an endowment fund subject to UMIFA, the historic dollar value of which is \$500. The other \$500 portion of the gift may be currently expended on the purpose designated by the donor.

As discussed above, the language authorizing appropriation of net appreciation for expenditure in Section 2 of UMIFA is qualified in that only so much of such appreciation "as is prudent under the standard established by Section 6" may be appropriated. Section 6 establishes a standard of ordinary business care and prudence, requiring that the governing board of an organization "exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision."<sup>67</sup>

In exercising such care and prudence, UMIFA specifically requires consideration of the "long and short term needs of the institution in carrying out its educational, religious,

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<sup>66</sup> As discussed below, an institution may decide that it is prudent to retain fund appreciation in order to retain the original purchase power of the fund. Nonetheless, if it were to so decide, the actual historic dollar value of the fund as that term is defined in UMIFA would not change.

<sup>67</sup> UMIFA §6.

charitable or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends and general economic conditions."<sup>68</sup> Thus, notwithstanding the fact that UMIFA embraces a total return concept allowing for expenditure of net appreciation on investment assets, the governing board of the organization must determine whether it is prudent to expend that appreciation, considering the specifically-enumerated factors, and may not expend the appreciation if it determines that to do so would be imprudent.<sup>69</sup>

This standard of care was selected specifically to subject boards of directors of not-for-profit organizations to a standard comparable to that of directors of business corporations and not that of private trustees.<sup>70</sup> It was derived from the standard of care applicable to managers of private foundations set forth in United States Proposed Treasury Regulations in the context of the prohibition on jeopardy investments introduced by the 1969 Tax Reform Act.<sup>71</sup>

It is important to recognize that UMIFA's scope is limited in that it only seeks to provide default rules for the expenditure of endowment fund appreciation. In other words, if a donor does not expressly state otherwise in making an endowment fund gift, Section 2 of UMIFA governs, authorizing the expenditure of net appreciation in excess of the historic dollar value of the endowment fund. However, amounts in excess of appreciation may be available for expenditure if permissible "under other law, the terms of the applicable gift instrument, or the charter of the institution."<sup>72</sup>

For example, if a donor makes an endowment fund contribution of \$1,000, and specifies in the gift instrument that \$100 from such fund may be expended each year for five years, then the institution holding such fund is authorized to make an appropriation

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<sup>68</sup> *Id.*

<sup>69</sup> The "ordinary business care and prudence" standard is discussed further below in this paper.

<sup>70</sup> See UMIFA Cmt. to § 6.

<sup>71</sup> Prop. Treas. Reg. § 53.4944-1(a)(2)(i). These regulations are now in final form. These regulations also moved from the consideration of each investment to looking at a particular investment in the context of the portfolio as a whole. *Id.*

<sup>72</sup> UMIFA §2. I have not yet come across any corporate charter that provides that endowment funds may be spent down. It is an interesting issue whether such a provision would trump a more restrictive gift instrument, especially if the donor were not aware of the charter provision. According to verbal advice given by the New York Attorney General's office, a charter of a New York not-for-profit corporation with language of this sort would not trump a more restrictive gift instrument if the donor were unaware of it.

of \$100 for expenditure in the first year. This is true even if the fund has not appreciated by \$100 and even if the appropriation takes the fund below the value of the initial contribution establishing the fund. If, under this hypothetical, the assets in which the \$1,000 endowment fund is invested enjoy a 5% return in the first year, the fund will have increased in value to \$1,050. After the \$100 annual expenditure appropriation, the fund's value will be \$950, which is \$50 lower than its initial value, yet this expenditure is not in violation of Section 2 of UMIFA, since it is specifically authorized in the gift instrument.<sup>73</sup>

An organization also may be subject to rules that are more strict than the default rule set forth in Section 2 of UMIFA. Section 3 of UMIFA states that Section 2 "does not apply if the applicable gift instrument indicates the donor's intention that net appreciation shall not be expended." Additionally, Section 3 states that:

[a] restriction upon the expenditure of net appreciation may not be implied from a designation of a gift as an endowment, or from a direction or authorization in the applicable gift instrument to use only "income," "interest," "dividends," or "rents, issues or profits," or "to preserve the principal intact," or a direction which contains other words of similar import.<sup>74</sup>

This language is not intended to allow for expenditure of appreciation contrary to donor intent but rather is a "rule of construction" in light of the fact that gift instruments may contain language that is a holdover from the private trust law area, but which does not in fact express actual donor intent.<sup>75</sup> Thus, if a gift instrument states that "only income" may be expended, net appreciation may nonetheless be expended under the default rule, due to the rule of construction in Section 3. However, if the gift instrument explicitly says, "net appreciation may not be expended," then the UMIFA default rule allowing for expenditure of net appreciation set forth in Section 2 would be overwritten.

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<sup>73</sup> Even though the full \$1000 gift is subject to restrictions on expenditure, it is not clear that the historic dollar value should be \$1000. Since the fund may be reduced by \$100 each year and thus may fall below \$1000, it would not make sense to set the historic dollar value at \$1000. On the other hand, if the initial historic dollar value were \$1000, perhaps that amount would be reduced, each year by \$100. This would not seem to comport with the definition of historic dollar value in UMIFA which does not appear to allow for any downward adjustments. UMIFA § 1(5). Hence, the historic dollar value may have to be set at \$500.

<sup>74</sup> UMIFA §3.

<sup>75</sup> See comment to UMIFA §3, 7A U.L.A. at pp. 493-494. I question whether, if asked, a donor's "intent" when creating an endowment fund would include the expenditure of all appreciation.

#### 4. Investment Management and Delegation

In addition to permitting the expenditure of appreciation and adopting the “ordinary business care and prudence” standard of care, UMIFA also grants broad investment authority to investment managers of endowment funds in any investments “otherwise authorized by law or the applicable gift instrument.”<sup>76</sup> Further, UMIFA specifically authorizes investments in real property, mortgages and partnerships and allows for investment of endowment funds in investment pools held by either the institution itself or third parties (such as mutual funds, REITs, partnership funds, etc.).<sup>77</sup> In creating such broad authority, the drafters specifically sought to distinguish the rules applicable to managers of endowment funds from those applicable to private trust fiduciaries.<sup>78</sup>

Additionally, as discussed above, trust fiduciaries were generally precluded from delegating investment management. UMIFA makes a clean break with this aspect of private trust law, permitting boards of directors to delegate investment authority not only to officers, committees and employees of the organization, but also to third-party investment advisors and managers.<sup>79</sup> In meeting its duty of care, the board that delegates investment management is left with the responsibility for overall investment policy and “selection of competent agents.”<sup>80</sup>

#### 5. The Adoption of UMIFA by the States

Since its promulgation by the NCCUSL, UMIFA has been adopted by every state other than Alaska, Arizona, Pennsylvania and South Dakota, and by the District of Columbia.<sup>81</sup> Although Florida enacted UMIFA, it repealed it effective January 7, 2003. As early as 1973, an advisory opinion to the New Hampshire legislature affirmed the

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<sup>76</sup> UMIFA § 4.

<sup>77</sup> *Id.*

<sup>78</sup> See UMIFA Prefatory Note, “Specific Investment Authority.”

<sup>79</sup> UMIFA § 5.

<sup>80</sup> See UMIFA, Cmt. to § 5. UMIFA also contains provisions permitting the release of donor-imposed restrictions on endowment fund assets. See UMIFA § 7. Although Section 7 explicitly does not limit application of the *cy pres* doctrine, it provides a statutory framework for seeking donor consent for a release of a restriction or, if the board has no means of access to the donor (e.g., if the donor has died), for making application for the release of a restriction in the courts. *Id.*

<sup>81</sup> State adoptions are listed at the legislative fact sheet with respect to UMIFA on the Uniform Law Commissioners website at: <http://www.nccusl.org>.

constitutionality of the application of a UMIFA-based statute to an endowment fund existing prior to adoption of the statute.<sup>82</sup>

Not every state that has adopted UMIFA, however, has adopted it verbatim. In Alabama, for example, the UMIFA-based statute that was originally adopted was applicable only to educational institutions. As of September 1, 2002, the statute applies more broadly. The UMIFA-based statute adopted in New York included a significant change to Section 2 of UMIFA. Like UMIFA, New York Not-for-Profit Corporation Law ("N-PCL") §513(c) permits expenditure of unrealized net appreciations with respect to readily marketable assets, but it diverges from UMIFA in that it prohibits the expenditure of unrealized appreciation with respect to non-readily marketable assets.<sup>83</sup>

The versions of Section 2 of UMIFA adopted in Massachusetts, New Mexico and New Hampshire state that the appropriation by an institution of net appreciation for expenditure in any year in an amount greater than 7% of the average fair market value of the endowment funds over at least the last 12 quarters creates a rebuttable presumption of imprudence on the part of the governing board of that institution.

The UMIFA-based statute adopted in Rhode Island adopts the historic dollar value concept and uses a definition of historic dollar value essentially the same as the UMIFA definition. However, it sets the historic dollar value of every endowment fund in existence in that state at the time the statute was enacted at the fair market value of the fund on either May 4, 1972 or, at the discretion of the organization, on the last day of either of the past two fiscal years of the organization. Thus, for endowment funds that had been in existence in that state for quite some time prior to 1972, or for funds that had otherwise enjoyed significant appreciation, a substantial amount of appreciation was locked into the historic dollar value. Finally, in the statute adopted in Rhode Island, historic dollar value must be adjusted to preserve the original purchase power of the endowment fund.<sup>84</sup>

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<sup>82</sup> *Opinion of the Justices*, 306 A.2d 55 (N.H. 1973).

<sup>83</sup> This divergence is discussed more fully in Part III, below.

<sup>84</sup> This aspect of the Rhode Island statute is discussed more fully in Part III, below.

Because of the considerable variation amongst the states,<sup>85</sup> it goes without saying that governing boards of charitable institutions must consider carefully the specific state laws applicable to their institutions. Corporations formed in one state but qualified to do business in another state and holding endowment funds in that state may be subject to the laws of both states. Additionally, multi-state organizations with individual corporate entities in more than one state must carefully consider the applicable laws of several states at once. In interpreting provisions of versions of UMIFA adopted in the states, authority discussing the analogous provisions of UMIFA, for example, in the NCCUSL's prefatory notes to UMIFA, is often consulted, although it is doubtful that such guidance could be relied on as binding authority in any state.

### **C. The Modernization of the Trust Law – The 1980s and 1990s.**

UMIFA went a long way toward liberalizing the investment rules applicable to charitable corporations. The standard of "ordinary business care and prudence under the facts and circumstances prevailing at the time" of the decision was considered much less restrictive than the standard applicable to trustees.<sup>86</sup> Additionally, the power to delegate investment management went a long way toward modernizing investment management for charitable boards of directors.

In 1987 the American Law Institute began a process of revising the Restatement of Trusts in order to make the standard of care required by trust fiduciaries more consistent with modern investment practice, and, in 1992, the Third Restatement of Trusts was released.<sup>87</sup> As pointed out by Professor Langbein, several states, including Iowa and Georgia, had already revised and modernized their prudent investor statutes prior to the national law project.<sup>88</sup>

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<sup>85</sup> This discussion is by no means an exhaustive one of all of the variations amongst the states that have adopted UMIFA-based statutes.

<sup>86</sup> The common understanding is that this standard absolves a board from all but gross negligence while the standard applicable to trustees holds them to a test of negligence. There is very little authority to support this distinction.

<sup>87</sup> John H. Langbein, "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 Iowa L. Rev. 641 (March 1996).

<sup>88</sup> *Id.* at 641, *citing* Iowa Code Ann. § 633.123 (West 1992), Ga. Code Ann. § 53-8-2(c).



In 1991, NCCUSL began a project to codify the Restatement's prudent investing principles as the Uniform Prudent Investor Act (the "Act"), which was promulgated in 1994. Although the Act emerges from private trust law, it is of direct relevance to charitable organizations. As discussed below, NCCUSL later incorporated the standard of care set forth in the Act into the Uniform Principal and Income Act, which sets forth rules governing the allocation of trust asset investment return to income on the one hand and principal on the other, and, at least as adopted by many states, is applicable to charitable trusts.

1. Uniform Prudent Investor Act

The prudent investor rule described in the Act shifts the focus of the prudence analysis shifts from results to process. Rather than the standard being a "prudent man" standard, the standard is one of the "prudent investor." More specifically, the investment range in which prudence is analyzed expands, portfolio diversification is emphasized, and trustees are permitted to delegate investment responsibility to a responsible professional. Taken in turn, the first significant change arises from analyzing prudence in the context of the entire investment portfolio, rather than scrutinizing individual decisions.<sup>89</sup> This is a marked change from the old standard and interpretations thereof, pursuant to which individual investments could be classified as imprudent. Second, the trustee should focus on the appropriate balance between risk and return, as dictated by the elements of the trust and the needs of the beneficiaries.<sup>90</sup> When forming an investment plan, the trustee is expected to consider various financial and social implications, such as economic conditions, tax consequences, the beneficiary's relationship to trust assets, the need for liquidity and the desire for capital.<sup>91</sup> The risk and return strategy should be "reasonably suited" to the trust.<sup>92</sup> Significantly, the Act states that no investment is barred categorically.<sup>93</sup> Instead, the Act requires that the trustee determine if an investment is worth its risk in the context of the entire portfolio. As a well-balanced portfolio is a *sine*

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<sup>89</sup> The Act, §2.

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> The Act, §2(e).

*qua non* of a modern investment portfolio, the Act incorporates diversification into the concept of prudence, with narrow exceptions.<sup>94</sup>

Finally, while outdated trust law prohibited a trustee from delegating responsibility, because s/he was expected to serve the beneficiaries as the settlor had intended, the Act permits delegation, while specifying oversight procedures.<sup>95</sup> In this scheme, investment and management tasks that a similarly-situated prudent trustee could delegate may be delegated, but the trustee remains under a duty of care and caution in selecting and supervising the agent. A trustee with special skills, however, or who presents her/himself as having special skills, has a duty to use those skills.<sup>96</sup> So a trustee cannot delegate important responsibilities s/he could perform as well as the agent.

Additional responsibilities include reviewing the trust's assets within a reasonable time of accepting a trusteeship to decide which investments to maintain and which to sell;<sup>97</sup> observing the duty of loyalty so that the trustee acts exclusively on behalf of the trust beneficiaries;<sup>98</sup> and acting impartially toward two or more trust beneficiaries, such that neither is favored.<sup>99</sup>

Like other elements of trust law, the prudent investor standard codified in the Act is a default rule that can be altered by the trust instrument. The primary application of the Act is to private family trusts, but it also influences responsibilities of charitable and pension trustees because, as the Restatement notes, "the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust." Transitively, the prudent investor standard in the Act also informs expectations of directors and officers of charitable corporations because their duties are "generally similar to the duties of the trustee of a charitable trust."<sup>100</sup> This is an interesting statement and is an articulation that

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<sup>94</sup> The exceptions noted in the official comments include when tax benefits dictate retaining already-existing trust assets or when a family business is placed in trust. Outside of these exceptions, diversification is critical. The Act, §3.

<sup>95</sup> The Act, §9.

<sup>96</sup> The Act, §2(f). This is a limitation on delegation power which is not articulated in UMIFA. Further, the trustee must ensure the trust is not being charged by an agent for services the trustee was expected to perform. If so, the trustee's fee should be lowered accordingly.

<sup>97</sup> The Act, §4.

<sup>98</sup> The Act, §5.

<sup>99</sup> The Act, §6.

<sup>100</sup> The Act, Prefatory Note.

NCCUSL believes the Act goes further toward liberalizing the investment rules applicable to trust trustees than did UMIFA for corporate directors.

The Act has been adopted in substantially similar form in more than 30 states.<sup>101</sup> A few states have made significant modifications. For example, Minnesota omitted the section requiring trustees to manage and invest trust assets impartially if there are two or more trust beneficiaries<sup>102</sup> and Arkansas inserted a presumption against delegation of trustee responsibilities to a single agent.<sup>103</sup> Both New York and California adopted versions of the Act<sup>104</sup> that each include certain variations, but which retain the same overall intent.<sup>105</sup>

## 2. Uniform Principal and Income Act of 1997: Trust Law's Long-Awaited Modernization

The Uniform Principal and Income Act (the "UPIA") was first approved in 1931, with a second draft endorsed roughly thirty years later. These acts addressed broad issues concerning the administration of assets held in trust or as part of an estate.<sup>106</sup> These earlier incarnations did not, however, address total return spending, and maintained the classic private trust law strict bifurcation between earned income, i.e., interest, dividends, rents and royalties, on the one hand and principal, or corpus (including appreciation), on the other. These earlier incarnations also incorporated a standard of care imposed on trustees that eventually was considered to be antiquated, particularly after the 1994 adoption of the Uniform Prudent Investor Act.<sup>107</sup>

In 1997, NCCUSL adopted a new version of UPIA that moved away from the strict distinction between income and principal and specified how particular types of assets and

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<sup>101</sup> Sally Whitney, *Prudent Investor Spotlights Needs-Based Planning*, at <http://www.tonysteuert.com/Articles/ADutyToAdvise.pdf>.

<sup>102</sup> UNIFORM LAWS ANNOTATED: BUSINESS AND FINANCIAL LAWS 301 (West, 2000).

<sup>103</sup> UNIFORM LAWS ANNOTATED: BUSINESS AND FINANCIAL LAWS 306 (West, 2000).

<sup>104</sup> See N.Y. EST. POWERS & TRUSTS § 11-2.1 and Cal. Prob. Code § 16045-16054.

<sup>105</sup> Both New York and California omitted the section on the duty of loyalty to the beneficiary and California also omitted the section about the duty of impartiality when there are two or more beneficiaries. See N.Y. EST. POWERS & TRUSTS LAW § 11-2.1 and Cal. Prob. Code § 16045-16054. Neither of these modifications have any impact for purely charitable trusts.

<sup>106</sup> These issues included the distribution of income earned during the probate of an estate, allocation between principal and income at the start, and through to the end, of an income interest, and determining the appropriate recipient of income where, upon the end of an income interest, income is either undistributed, or accrued but unreceived. UPIA, Pref. Note, 7B U.L.A. 131, 133 (1977).

<sup>107</sup> See Part IV, below, for a discussion of the evolving applicable standards of care.

earnings are to be treated for purposes of income and principal rules given the ever expanding investment options.

UPIA embraces the notion in modern portfolio theory that appreciation should be available for expenditure within certain limitations. Recall that UMIFA, which allows for expenditure of appreciation so long as it is prudent to do so, maintains a strict bifurcation between appreciation on the one hand and historic dollar value on the other. UPIA arguably goes further than UMIFA, granting trustees the discretion to adjust between the principal and income of funds held in trust provided that certain conditions are met. This provision is contained in §104(a). It states that:

A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages the trust as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in Section 103(a), that the trustee is unable to comply with Section 103(b).<sup>108</sup>

The purpose behind the power to adjust is to "enable a trustee to select investments using the standards of the prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest, dividends, and rents."<sup>109</sup> Also consistent with the prudent investor rule and modern portfolio theory, "the power to adjust...is to be exercised by considering net income from the portfolio as a whole and not investment by investment."<sup>110</sup>

One commentator explains that UPIA's language concerning the degree of adjustment permitted can be read both narrowly or liberally. The narrow reading is that the discretion is limited to the difference "in trust income resulting from the trustee's investment decisions."<sup>111</sup> The liberal reading is that the discretion is as broad as might be

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<sup>108</sup> UPIA § 104(a). In addition to adjustments pursuant to §104, UPIA permits transfers from income to principal in two other circumstances. With some exceptions, a trustee can transfer to principal a "reasonable amount of the net cash receipts from a principal asset that is subject to depreciation." As with the power to adjust, this power to transfer is discretionary and requires compliance with §103(b). UPIA also permits transfers from income to reimburse principal.

<sup>109</sup> UPIA § 104, cmt. at 143.

<sup>110</sup> *Id.* at 145 (quoting Restatement of Trusts 3d: Prudent Investor Rule §227, Comment *i*).

<sup>111</sup> See Lyman V. Welch, "Brave New World of Total Return Laws," *Trusts and Estates* 24, 26 (June 2002).

required "to promote fair sharing of total return."<sup>112</sup> As with the power to expend appreciation authorized by UMIFA, the power to adjust in Section 104(a) of UPIA is a default rule that applies to trust administration, unless the terms of the trust clearly indicate an intent to deny the power.<sup>113</sup> Significantly, the definition of "terms of the trust" for purposes of UPIA authorizes the trustee to look beyond the actual language of the trust and also consider "the manifestation of the intent of a settlor or decedent with respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or spoken words or by conduct."<sup>114</sup> The commentary in the Uniform Laws Annotated states that the trust instrument "should specifically refer to the power to adjust if the settlor intends to forbid its use."<sup>115</sup> (This provision is similar to Section 3 of UMIFA regarding the need for a donor to state explicitly that appreciation may not be expended.)

The power to adjust is applicable to charitable trusts, but only so long as "both income and principal are . . . set aside for charitable purposes."<sup>116</sup> In other words, UPIA applies to trusts that hold charitable assets and where income and principal are both used solely for charitable purposes. However, UPIA does not apply to trusts, such as charitable lead or remainder trusts, where a non-charitable person is a beneficiary.<sup>117</sup>

A condition to the discretionary power to adjust is that the trustee must "invest[ ] and manage[ ] trust assets as a prudent investor . . ." <sup>118</sup> In this regard, the trustees must consider a series of factors, to the extent they are relevant. These factors are:

- (1) the nature, purpose, and expected duration of the trust;
- (2) the intent of the settlor;
- (3) the identity and circumstances of the beneficiaries;

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<sup>112</sup> *Id.*

<sup>113</sup> UPIA § 104(f).

<sup>114</sup> UPIA § 102(12). This arguably permits a broader look at settlor intent than is afforded under UMIFA to donor intent.

<sup>115</sup> See Comment to § 104(f) of UPIA.

<sup>116</sup> UPIA § 104(c)(4).

<sup>117</sup> It should be remembered that both charitable lead and charitable remainder trusts are governed by explicit provisions of federal tax law regarding the determination of income interests and any deviation would cause adverse tax consequences.

<sup>118</sup> UPIA §104(a).

- (4) the needs for liquidity, regularity of income, and preservation and appreciation of capital;
- (5) the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;
- (6) the net amount allocated to income under the other sections of this [Act] and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;
- (7) whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;
- (8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and
- (9) the anticipated tax consequences of an adjustment.

The majority of the above-listed factors derive from the Uniform Prudent Investor Act §§2(c) and 3, discussed above.<sup>119</sup> The goal of this integration was to ensure that "comparable factors will apply to investment decisions and decisions involving the power to adjust."<sup>120</sup>

Along with its focus on adjustment between income and principal, UPIA provides additional guidance for trustees to distinguish between principal and income and attempts

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<sup>119</sup> UPIA §104, cmt. at 145. Factors (b)(3) - (b)(4), (b)(6) and (b)(8) originate from UPIA §2(c); (b)(5) originates from UPIA § 3.

<sup>120</sup> *Id.* UPIA also enumerates eight instances when a trustee is barred from exercising the power of adjustment. Seven of the eight address tax implications. UPIA § 104(c). The first four aim to "preserve tax benefits that may have been an important purpose for creating the trust," and three others concern avoiding adverse tax consequences.

to deal with this allocation in light of the types of investment vehicles now available to investment managers.<sup>121</sup>

### 3. Adoption of the Act by the States – Equitable Adjustment and Unitrust Conversion

Since approval of UPIA in 1997, the majority of states and the District of Columbia have passed some form of total return legislation applicable to trusts.<sup>122</sup> Typically one of two schemes is adopted.<sup>123</sup> The first, termed “equitable adjustment,” essentially tracks UPIA and allows discretionary adjustment between income and principal.<sup>124</sup> The second is a unitrust model, which permits a trustee to “convert an income trust to a unitrust.”<sup>125</sup> Such conversion “changes the definition of income for the trust, substituting a distributable amount determined as a percentage of trust assets revalued at least annually.”<sup>126</sup> Both methods are in accordance with the total return model in that they allow income and remainder beneficiaries to “share as partners in the total investment results,” thereby freeing the trustee from rigid investment allocation requirements.<sup>127</sup>

### D. **Revisions to UMIFA – The Demise of Historic Dollar Value? – Developments in the 21<sup>st</sup> Century**

The power of adjustment under UPIA is of primary relevance in the private trust context. What is important about UPIA is that it has now gone further in many ways than

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<sup>121</sup> For example, property other than cash distributed to a trust by an entity in which the trust holds an investment is treated as principal. UPIA §401(c)(1). Further, derivatives and options held as part of an investment portfolio are generally characterized as principal. UPIA §414.

<sup>122</sup> State adoptions of UPIA are listed at the legislative fact sheet with respect to UPIA on the Uniform Law Commissioners website at: <http://www.nccusl.org>.

<sup>123</sup> See Welch, "Brave New World of Total Return Laws," *supra* note 111 at 24. Some state legislation combines the two models. Welch's article enumerates five different schemes potentially available to the trustee under the equitable adjustment approach, and notes that just as all equitable adjustment schemes incorporate §104(a) verbatim, they also include UPIA's definition of “terms of the trust,” which relates to impartiality.

<sup>124</sup> *Id.*

<sup>125</sup> *Id.* See also Joel C. Dobris, in "Real Return, Modern Portfolio Theory, and College, University, and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules," 28 REAL PROPERTY, PROBATE AND TRUST JOURNAL 49, n.20 (1993). Dobris describes a unitrust as a trust that "draws no distinction between income and principal, and a set percentage of asset value is paid out annually in lieu of income" (*citing* BLACK'S LAW DICTIONARY 1534 (6<sup>th</sup> ed. 1990)).

<sup>126</sup> *Id.*

<sup>127</sup> *Id.* Pennsylvania, which has not adopted a UMIFA-based statute, allows Pennsylvania not-for-profit corporations to adopt a total-return spending policy that is essentially a unitrust model. See 15 Pa.C.S. § 5548(c) (2003).

UMIFA in granting discretion to fiduciaries. As of the time of writing this article, NCCUSL is considering promulgating a significantly revised version of UMIFA and a committee has begun the redrafting process (“Revised UMIFA”).<sup>128</sup> Although the current draft is by no means final, the draft contains several significant changes from the current UMIFA. First, it explicitly applies to charitable trusts. Second, it abandons the concept of historic dollar value. Finally, it incorporates the standard of care set forth in the Act that was later incorporated into UPIA.

#### 1. Charitable Trusts.

As discussed above, UMIFA does not clearly state its applicability to charitable trusts, leading to some confusion. Many states have adopted UMIFA as part of their not-for-profit corporate law, thus not extending it explicitly to trusts.<sup>129</sup> Further, there is some question as to the applicability of UPIA to charitable, as opposed to private, trusts (although several states that have adopted UPIA, apply its terms to charitable trusts).

In my opinion, it makes no sense to apply different laws to the maintenance of charitable assets held in trust on the one hand or by a corporation on the other.<sup>130</sup> The distinction between the two types of entities can have an impact, because courts at time have adhered to the formalistic distinction between the two organizational forms.<sup>131</sup> As the Delaware Supreme Court stated, “the creator of a charitable enterprise recognizes that different legal rules govern . . . and selects a form with those rules in mind.”<sup>132</sup>

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<sup>128</sup> The most recent April, 2003 version of this draft may be obtained at [www.nccusl.org](http://www.nccusl.org).

<sup>129</sup> See, e.g., the New York Not-for-Profit Corporation Law, § 511 et seq.

<sup>130</sup> As mentioned above, as early as 1960, Professor Kenneth Karst pointed out the illogic of applying different rules and standards to the two forms of organization, calling for a “law of charities.” See Karst, “The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility,” *supra* note 1 at 436.

<sup>131</sup> See *Oberly v. Kirby*, 592 A.2d 445, 466-67 (Del. Sup. Ct. 1991), cited in Evelyn Brody, “The Limits of Charity Fiduciary Law,” *supra* note 17 at 1416.

<sup>132</sup> *Id.* Professor Evelyn Brody has suggested that this “selection” process may not be as deliberate as the Delaware Supreme Court suggests, noting that, “[i]n practice, it must be admitted, rarely does the founder of a charity carefully consider the legal difference and make a choice based on the advantages of organizational form.” *Id.* Brody in fact notes that the preference for the corporate form in the United States is in fact partly a “historical accident,” and numerous factors, including “normative pressures,” such as the “professional training of the charity advisor (particularly attorneys),” lead to the vast majority of charities being organized in corporate form. While I agree with this latter statement that there is a tendency to favor the corporate form, my experience has been that founders and their advisors frequently consider the advantages or disadvantages of one form of organization over the other.



The Revised UMIFA defines an “Institution,” to which the act applies as “any nonprofit corporation, trust, unincorporated association, government or governmental subdivision or agency or any other legal entity organized and operated for [charitable purposes].”<sup>133</sup> However, even Revised UMIFA excludes trusts that have both charitable and also one or more private beneficiaries.<sup>134</sup>

## 2. The Demise of Historic Dollar Value?

Perhaps the most radical change in Revised UMIFA is its abandonment of the concept of historic dollar value. This concept has been applicable to organizations subject to UMIFA since the early 1970s and establishes a baseline amount of an endowment fund that may not be expended. Since the promulgation of UPIA, granting trustees—even of private trusts—the discretion to adjust between trust income and principal without any absolute restriction on the allocations to income, it may have been inevitable that a project would be initiated to remove the historic dollar value restriction from UMIFA. It certainly seems a natural result of modern portfolio theory.

Section 5(a) of Revised UMIFA states that an institution “may expend so much of an endowment fund as the institution determines to be prudent for the uses, benefits and purposes for which the endowment fund is established.” Revised UMIFA also outlines a standard of care, stating that in making its determination to expend, “the institution shall exercise reasonable care, skill, and caution and shall consider,” the terms of the gift, the purpose of the institution, the purpose of the endowment, the long-term needs of the organization in carrying out its purposes, the organization’s other resources, general economic conditions, the possible effect of inflation or deflation, the preservation of the purchasing power of the fund, the institution’s investment policy, and the duration of the endowment.<sup>135</sup>

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<sup>133</sup> Revised UMIFA § 2(3).

<sup>134</sup> Preliminary comments to the draft state that “[t]he term ‘trust’ is intended to mean a trustee acting under a charitable trust. The term does not include charitable remainder trusts and charitable lead trusts.” The comments further state that “a charitable remainder trust held by a charity as trustee for the benefit of the donor during the donor’s lifetime, with the remainder interest held by the charity, is not an institutional fund.”

<sup>135</sup> Revised UMIFA § 5(a).

The preliminary comments to Section 5(a) of the proposed act explain that this new approach “abandons the use of historic dollar value as a floor for expenditures and provides more flexibility to the governing board in making decisions about whether to expend any part of an endowment fund.” The drafters further explain that in some years, an institution may decide to accumulate all of its income, and in others, it may decide to make an appropriation, even if a fund has no investment return that year. They seek to remove constraints from expenditure of appropriate amounts during times of economic down-turn. They further note that fiduciary duties on decision-makers with respect to an endowment fund and the watchful eyes of state attorneys general will act as constraints on institutions in protecting endowment fund assets.<sup>136</sup>

The drafters of Revised UMIFA have not, at least in the current draft, limited the right of an organization to expend below historic dollar value solely to situations where *not doing so* would cause the directors of the organization to breach their fiduciary duties.<sup>137</sup> The comments to this section of Revised UMIFA state that the drafters have noted a conservative trend in endowment fund maintenance. In their experience, “institutions have operated more conservatively than historic dollar value would have permitted.”<sup>138</sup> Organizations, they explained, have no incentive to spend all they are permitted to expend, and good practice has included the maintenance of the purchasing power of the fund, even though UMIFA itself does not so require.<sup>139</sup>

Although organizations may on balance act conservatively with respect to their endowment funds, at the time of writing, many endowment funds -- particularly those

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<sup>136</sup> While this revision may be said to bring UMIFA in line with UPIA, it also can be viewed as going farther. Recall that UPIA states that a trustee has the power to adjust only if not doing so would lead to the trustee not being able to administer the trust impartially based on what is fair and reasonable to all beneficiaries. This is a significant restriction on the power to adjust, for it grants the power only to the extent that not exercising such power would actually cause the trustee to violate its duty of fairness. Although a charitable organization does not have two distinct beneficiaries, it does have a tension with respect to its endowment funds in providing income for current expenditure on the one hand and protecting the life of the funds on the other.

<sup>137</sup> Note that one reading of the power to adjust granted by UPIA is that the trustee is allowed to adjust only to the extent of income and appreciation generated by her/his own investment decisions. See Welch, “Brave New World of Total Return Laws,” *supra* note 111 at 24. Some state legislation combines the two models. If this is an accurate reading of UPIA, it further shows the divergence between UPIA and UMIFA in the flexibility granted to decision-makers with respect to endowment fund assets.

<sup>138</sup> Revised UMIFA, Prelim. Cmts to § 5.

<sup>139</sup> *Id.*

established during the second half of the 1990s -- are in fact close to or below historic dollar value. While organizations may have acted conservatively during the period of the run-up of the market, during the current economic climate it is not clear how the urgent need for cash for operations will play a role in the decision to expend below historic dollar value.<sup>140</sup> At the very least, the historic dollar value concept provided a baseline restriction that could be easily articulated to boards of directors.<sup>141</sup> If Revised UMIFA is promulgated and is widely adopted by the states, time will tell whether the flexibility it provides comes at the expense of the maintenance of endowment funds.

### 3. Conformity in Standard of Care

Section 4 of Revised UMIFA contains a straightforward prudence standard governing the investment and management of endowment fund assets. It says, "[a]n institution shall invest and manage an institutional fund as a prudent investor would."<sup>142</sup> The section elaborates that trustees should look to the terms of the statute for "guidance as to the meaning of prudence for an institution making decisions consistent with this [act], except as may be provided by other law relating to governmental institutions and their institutional funds."<sup>143</sup> By defining the standard as that of the "prudent investor," Revised UMIFA adopts the language of the Act.<sup>144</sup> Although it is a standard derived from current

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<sup>140</sup> My experience over the past several years in dealing with endowment funds that have depreciated below their historic dollar value is that boards of directors are resentful of the current law holding them to preserving historic dollar value and without that discipline (and even with it), would be inclined to continue their annual draw down on these funds, further depleting them. These decisions would undoubtedly be rationalized as prudent under Revised UMIFA, and perhaps they would be prudent if they permitted an organization to weather the current downturn in the market. My fear is, however, that it is the path of least resistance to continue a draw-down on endowment funds, rather than reduce staff, curtail certain operations or redouble fundraising efforts.

<sup>141</sup> Pennsylvania, one of the few states that has not adopted a UMIFA-based statute, instead has an elective endowment fund maintenance regime applicable to charitable corporations that most closely represents a unitrust model -- organizations may select a percentage of the average fair market value of the organization's assets that must be spent in a given year. See 15 Pa.C.S. § 5548(c). Under this regime, an organization may in fact spend an endowment fund below its historic dollar value if earnings and appreciation do not exceed the spend rate. However, the organization's selected spend rate must be consistent with the preservation of the "real value" of the endowment fund assets, and in no case may the percentage be set higher than 7%. *Id.* Unlike the Pennsylvania statute, Revised UMIFA would not include a statutory cap on the amount a board may draw-down from its endowment fund assets. I am concerned that this may leave too much discretion to the board.

<sup>142</sup> Revised UMIFA § 4(b).

<sup>143</sup> *Id.*

<sup>144</sup> See Preliminary Comments to Section 4, Revised UMIFA.

trust law, the drafters note that it is "consistent with the business judgment standard under corporate law, as applied to charitable institutions."<sup>145</sup> The Act's standard was used in order to apply consistently the standards of the Act to all charitable institutions.<sup>146</sup>

As discussed above, the prudence standard in the current UMIFA is one derived from United States Treasury regulations dealing with the investment responsibility of managers of private foundations.<sup>147</sup> This standard was adopted specifically in order to establish a standard of care "comparable to that of a director of a business corporation rather than that of a private trustee."<sup>148</sup> Nonetheless, it is preferable to have one standard apply to fiduciaries with respect to investment assets held by charitable organizations regardless of whether they operate in corporate or in trust form. Further, as history has shown, the actual standard that governs is a function of glosses and interpretations of the standard by courts and commentators, and a single standard might serve to put attorneys general, judges and commentators on notice that these fiduciaries are meant to be subject to the business director, and not the more restrictive private trust, standard. While it is certainly not clear whether Revised UMIFA, if promulgated by the NCCUSL, will be adopted widely by the states, and, if adopted, will in fact be adopted as applicable to all charitable organizations, regardless of their form of organization, Revised UMIFA's adoption of the standard of care set forth in the Act and followed in UPIA is a step in the right direction.

#### **E. Other Legal, Non-Statutory Constraints**

The statutory legal rules discussed above are by no means the only constraints on not-for-profit organizations in their management of charitable assets. Two important areas of constraints are socially responsible investing and the requirement that organizations act for the public benefit. The first involves the notion that an organization should or must not take ethical considerations into account in investing charitable assets. The second considers whether an organization has a duty to the public community in

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<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> See Treas. Reg. § 53.4944-1(a)(2). See also Comment to UMIFA § 6.

<sup>148</sup> Comment to UMIFA § 6.

which it is organized and operates. Both may involve endowment funds which have been discussed above or may, more broadly, be applied to any investment assets held by an organization.

### 1. Socially Responsible Investing

SRI Generally. Socially Responsible Investing (“SRI”) is not a legal term, but rather is a term of art broadly used in the investment community to mean choosing investments that align with institutional values and missions.<sup>149</sup> Much has been written on SRI, and the following is only a brief discussion of the issues it raises.

There are three primary components to SRI, which exist either individually or in concert. The first component, and the one most commonly identified with SRI, is screening. The SRI screening process involves pinpointing certain criteria in an investment to determine if the investment is consistent with a given institution's values. Screens can be negative—for example, eliminating companies that profit from alcohol, gambling, tobacco, pornography, firearms or defense—or positive—for example, giving extra weight to companies that have strong reputations for promoting minorities and women, good maternity policies or sound environmental records.<sup>150</sup>

The second component of SRI is shareholder activism, which became popular in the late 1980s and early 1990s when certain shareholders wanted the companies in which they owned an interest to divest from South Africa in protest of that country's racist apartheid system. Shareholder activism takes three forms: filing shareholder resolutions, communicating directly with corporate leadership and voting proxies.<sup>151</sup>

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<sup>149</sup> "The New Fiduciary Duty for Institutional Investors," *Business Ethics*, Spring 2003 at [http://www.business-ethics.com/fiduciary\\_duty\\_for\\_institutional\\_investors.htm](http://www.business-ethics.com/fiduciary_duty_for_institutional_investors.htm).

<sup>150</sup> *Id.* The most popular negative screen is the "sin screen," which eliminates liquor, tobacco and gambling companies; it has been used by universities and churches for over 100 years. Chris Lott, Ritchie Lowry and Reid Cooper, "Subject: Strategy – Socially Responsible Investing," *The Investment FAQ* at <http://www.invest-faq.com/articles/strat-sri.html>. Additionally, students at several universities have lobbied for screens against companies in Burma and Israel, and other investors are currently considering screens to eliminate companies that profit from the 2003 Iraq war. Since positive screens are intangible, often investors search for corporations which can be identified as meeting certain standards, such as the "best in the industry," or the "try harder" corporation. Corporations meeting these standards may not be perfect, but they are determined at least to be better than the rest in a given sector. *Id.*

<sup>151</sup> Shareholder activism is currently increasing, after a lull in the mid and late 1990s, with popular issues including banning sexual orientation discrimination, adopting human rights principles in China, linking executive pay to social and environmental criteria, and phasing out or labeling genetically engineered food

The final component of SRI is community investing, which usually signifies investing in underserved areas, both rural and urban.<sup>152</sup> Community investing has been growing rapidly of late due to both a campaign in the SRI community to get investment managers to allocate one percent of investment assets to community investing<sup>153</sup> and also recent investment successes of affordable housing.<sup>154</sup> Today, at least two mutual funds invest exclusively in community development.<sup>155</sup>

Within the investment community, SRI is growing rapidly, both in size and reputation; in 1984 there were \$40 billion in SRI accounts, in 1997, about \$1.2 trillion.<sup>156</sup> In the 1970s there were only a few SRI mutual funds, but by 1997 there were 144.<sup>157</sup> By the end of 2001, SRI mutual funds numbered 230.<sup>158</sup> Further, as they have become more established, these mutual fund investments have on balance enjoyed favorable returns. While only a few years ago, not one SRI mutual fund earned a five-star rating, now more than 21 percent do—which is twice the average rate for mutual funds generally.<sup>159</sup> Further, in 1999, both the Domini Social Index and the Citizens Index earned greater returns than the S&P 500 for both one- and three-year periods.<sup>160</sup> SRI funds with assets of

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products. Bara MacNeill, et. al., "The Leading Social Investment Indicators Report," (SRI World Group, 2002). As an example, The New York City Employees Retirement System (NYCERS) passed a shareholder resolution that Cracker Barrel should bar sexual orientation discrimination. Winning a 58 percent vote, it was the first social resolution to receive over 50 percent. In response, Cracker Barrel's board unanimously voted to bar sexual orientation discrimination. In addition, universities such as Columbia, Yale, Stanford, Tufts, Cornell, Swarthmore and the University of Minnesota have established advisory committees on SRI, usually containing students, faculty and alumni.

<sup>152</sup> Bara MacNeill, et. al., "The Leading Social Investment Indicators Report," *supra* note 151.

<sup>153</sup> *Id.*

<sup>154</sup> "The New Fiduciary Duty for Institutional Investors," *supra* note 149.

<sup>155</sup> Bara MacNeill, et. al., "The Leading Social Investment Indicators Report," *supra* note 151. One additional benefit of the growing interest in SRI is greater voluntary corporate reporting of the corporation's activities. Nike, Reebok, Liz Claiborne and others have submitted to inspections and allowed the Fair Labor Association to release a report on the labor practices in their supplier plants worldwide. Currently the reports are more descriptive than evaluative, but they are an important first step.

<sup>156</sup> Anita Saville, "Investing in Women," *Purse Strings: Investment News for Women*, at <http://www.feminist.com/resources/artspeech/work/sri.htm>.

<sup>157</sup> Ritchie Lowry, "Subject: Strategy – Socially Responsible Investing," *supra* note 150; Anita Saville, "Investing in Women," *supra* note 156.

<sup>158</sup> Marjorie Kelly, "The Fourth Annual Social Investing Awards," *Business Ethics*, Spring 2003, at <http://www.business-ethics.com/SRI-01-02.htm>.

<sup>159</sup> Emily Hall and Jon Hale, "How Do Socially Responsible Funds Stack Up?" at <http://news.morningstar.com/news/MS/Commentary/990917com.html>.

<sup>160</sup> Anita Saville, "Investing in Women," *supra* note 156.

\$100 million or more outperformed regular funds even in the difficult economic climate of 2002.<sup>161</sup>

SRI and Fiduciary Standards of Care. Investors of non-profit funds may question whether SRI is an element—or a violation—of fiduciary duty. Some theorists argue that any limitation on the vast array of available investments by the investor is a violation of fiduciary duty because the fiduciary's sole interest should be in generating the most favorable return given an appropriate level of risk. Commentators have argued that SRI is not an acceptable investment strategy by a fiduciary if the investment return under such strategy would be lower than the investment return under an investment strategy that is neutral from a moral, social, political or ethical perspective.<sup>162</sup>

For non-profit and foundation investing, however, screening for particular social issues of concern to the non-profit may be completely in tune with fiduciary duty, if not a requirement of it.<sup>163</sup> As Sarah Stranahan, Treasurer of the Needmor Fund puts it, "our commitment for mission-related investing comes out of an interpretation of our fiduciary responsibility, which is that all the funds have received tax benefits for being charitable dollars, and therefore, the funds need to work for the public good."<sup>164</sup> W.B. McKeown states it slightly differently, saying, "being true to the mission of the charity may require that the governing board address the social responsibility of its investment decisions."<sup>165</sup> A possible method for investors to avoid violations of fiduciary duty while engaging in SRI is to incorporate into the organization's written investment plan its

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<sup>161</sup> Marjorie Kelly, "The Fourth Annual Social Investing Awards," *supra* note 158.

<sup>162</sup> See John Langbein and Richard Posner, "Social Investing and the Law of Trusts," 79 Mich. L. Rev. 72, 96-97 (1980). In fact, the duty of loyalty contained in the Uniform Prudent Investor Act specifically warns fiduciaries (admittedly, the Act was written primarily, if not exclusively, with private trust management in mind) that "[n]o form of so-called 'social investing' is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefited by pursuing the particular social cause." Comment to §5, the Act, *citing id.* The Comment further notes that commentators who argue in favor of SRI typically concede that the duty of loyalty is paramount, and instead promote SRI by arguing that "particular schemes of social investing may not result in below-market returns." *Id.*, *citing* Marcia O'Brien Hylton, "'Socially Responsible' Investing: Doing Good Versus Doing Well in an Inefficient Market," 42 Amer. U.L. Rev. 1 (1992).

<sup>163</sup> The Institute of Fiduciary Responsibility exists to advocate for an expanded definition of fiduciary duty, one that includes concern for labor, human rights, community, the environment, and corporate accountability.

<sup>164</sup> "The New Fiduciary Duty for Institutional Investors," *supra* note 149.

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findings in favor of SRI, including a belief that SRI is a demand of the organization's mission.

Notwithstanding the concerns about SRI from the perspective of fiduciary duty, SRI is on the rise. This is probably because of socially responsible funds' success over the last few years. Further, the impact of an average screening process on the selection of investments is not as great as critics would suggest; the Methodist Church claims its screens eliminate only four percent of the stocks in the S&P 500.<sup>166</sup> For the five years ended January 31, 2003, its General Board of Pension and Health Benefits fund returned 3.9 percent annually. What all of this means for the non-profit board of directors who have espoused modern portfolio theory is that if the organization is also committed to SRI, that commitment should be articulated as part of the organization's mission, and incorporated into its investment policy. Given the range of SRI vehicles available, it should not detract from pursuing modern investment management.

## 2. Public Benefit.

General. One interesting area of inquiry regarding charitable asset maintenance involves the possibility that the activities of a not-for-profit organization may be scrutinized from the perspective of the community as a whole in which the organization operates or is organized, rather than from the perspective of how to manage the organization's investment assets to maximize the benefit to the organization in light of its purposes.

Even within market capitalism, all organizations are considered to be subject to oversight and scrutiny by governmental apparatuses. This is considered all the more necessary and justified in the context of charitable organizations. As elaborated by Professor Karst, both "the man on the street" and the "enlightened foundation president" knows that "charitable funds are public funds."<sup>167</sup>

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<sup>166</sup> "The New Fiduciary Duty for Institutional Investors," *supra* note 149.

<sup>167</sup> Kenneth L. Karst, "The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility," 73 Harv. L. Rev. 433 (January 1960). Karst argues that that private charity is "permitted to exist" because it serves a public purposes, and all members of the public, in fact, contribute to private philanthropy by virtue of the tax exemption enjoyed by many not-for-profit organizations. *Id.* at 433-434. Karst also suggests that the



Although Karst's discussion in this regard focuses on the interest in the public, via state attorneys general, in monitoring the activities of not-for-profit organizations to require that they comply with applicable law,<sup>168</sup> there is a growing concern in the not-for-profit sector that state attorneys general may consider not-for-profit organizations accountable for the impact of their investment activities on the communities in which they operate. This has been brought to national attention recently by the litigation brought by the Pennsylvania Attorney General when the Hershey Trust sought to sell its controlling interest in the Hershey Corporation in order to diversify its holdings.<sup>169</sup>

The following examines the recent litigation involving the Hershey Trust. A full analysis of the authority in this area is beyond the scope of this article. However, the Hershey Trust case indicates a potential constraint on the board of a not-for-profit organization to pursue a basic tenet of modern portfolio management – diversification of the organization's holdings.

The Hershey Trust Case: A Community Interest in Charitable Trusts? The Hershey Trust was endowed in 1909 for the benefit of the Milton Hershey School, an institution for orphaned children in Hershey, Pennsylvania.<sup>170</sup> In July 2002, seeking to diversify its portfolio, the Hershey Trust Company offered for sale the controlling interest in the Hershey Foods Corporation.<sup>171</sup> Despite receiving several handsome bids, the offer met intense opposition from state and local interests, including the Pennsylvania Attorney General who filed suit. A local court preliminarily barred the sale, and the injunction was upheld on appeal. Though the case was ultimately dismissed as moot, the trustees and

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increasing overlap between the private and the public sectors in providing needed social services to members of the public warrants state oversight of private charitable activities. *Id.* at 479-480.

<sup>168</sup> Karst was writing in 1960, when only a handful of states even required registration by all charities with the state attorney general's office.

<sup>169</sup> Cases in which state attorneys general have successfully enjoined, compelled, or second-guessed a charitable organization's activities in the interests of the general public interest are scant, and there cannot be said to be any coherent authoritative law in this area. Although there are undoubtedly instances where it can be argued that the general public has an interest in a charitable organization's activities, particularly where the organization operates in tandem with, at odds to, or in the absence of, governmental social services, I am a little cynical about the motivations of state attorneys general to litigate in this area. State attorneys general are elected or appointed officials who are often looking toward higher political offices.

<sup>170</sup> The Hershey Trust Company is the trustee of the School Trust, and the same board of directors governs each.

<sup>171</sup> Orphans' Court, p. 10.

managers promised to submit for review any future plans to sell the trust's interest in the Hershey Food Corporation to the state Attorney General.

The Hershey Trust case is significant to the extent that it suggests that a trustee “owes fiduciary duties to the public at large,” and rather than solely to its stated charitable mission.<sup>172</sup>

### **The General Public as the "Ultimate Beneficiary".**

Pursuant to his *parens patriae* power and his duty to oversee the state's charitable trusts,<sup>173</sup> Pennsylvania Attorney General Michael Fisher requested an injunction “prohibiting the sale of the School Trust’s interest in Hershey Foods.”<sup>174</sup> Fisher (a candidate for governor at the time) raised issues of the impact on the public, as well as the Board’s abuse of discretion in commencing the bidding process.<sup>175</sup>

Acknowledging that the sale would likely augment the value of the trust, Fisher argued that such benefit was offset by the adverse impact the sale could have on the community, including but not limited to lost job opportunities.<sup>176</sup> Moreover, he claimed that the “ultimate beneficiary and real party in interest of all charitable trusts is the general public to whom the social and economic advantages of the trusts accrue.”<sup>177</sup> It follows, he argued, that as Attorney General, he had a duty of “protecting the public against any social and economic *disadvantages* which may be occasioned by the activities and functioning of public charities....”<sup>178</sup> Accordingly, Fisher argued that the harm to the residents of Hershey was sufficient to halt the sale of the stock, despite any advantage the sale would bring to the trust's named beneficiaries by diversifying its portfolio.

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<sup>172</sup> “Hershey Trust case explores community interest in charitable trust decisions,” TRUST LETTER, 3 (December 2002).

<sup>173</sup> *Citing In re Pruner’s Estate*, 390 Pa. 529, 532, 136 A.2d 107, 109 (1957)

<sup>174</sup> “Pa. Court Blocks Sale of Hershey Foods By School Officials.” 9 PRIVATE EDUCATION LAW REPORT 1 (November 2002).

<sup>175</sup> Orphans’ Court, p. 5.

<sup>176</sup> Petition for Citation For Rule To Show Cause Why A Proposed Sale Of Trust Assets Constituting The Controlling Interest In Hershey Foods Corporation Should Not Be Conditioned Upon Court Approval, p. 4 (August 12, 2002), pp. 3-4.

<sup>177</sup> *Id.* at 4 (citing *Pruner’s Estate*).

<sup>178</sup> *Id.* (emphasis in original).

### **Court Enjoins Hershey's Sale.**

While the court did not issue a final ruling regarding Fisher's ultimate beneficiary theory, it did consider his reasoning a sufficient basis for a temporary injunction. Hershey Trust was enjoined from "enter[ing] into any agreement or understanding that would or could commit the [Trust] to a sale or other disposition of any or all shares of Hershey Foods Corporation held as the corpus of the [School] Trust." <sup>179</sup>

Strongly endorsing the Attorney General's standing, the Orphan Court embraced much of his argument, granting "the Attorney General the authority to inquire whether an exercise of a trustee's power, even if authorized under the trust instrument, is inimical to the public interest." <sup>180</sup> In support of this holding, the court stated that "[p]roperty given to a charity is in a measure public property, *McKee Estate*, 108 A.2d 214 (Pa. 1954), and the beneficiary of charitable trusts is the general public to whom the social and economic benefits of the trust accrue." <sup>181</sup> Later in the opinion, the court added that the "socio-economic benefits of a charitable trust extend beyond the designated beneficiaries to the public itself." <sup>182</sup>

The opinion also doubted the Trust's proffered reason for initiating the sale, namely an "exploration [of a] diversification policy." The court cited two reasons for doubting the Trust's claimed need to diversify. <sup>183</sup> First, they were under no such obligation, as Pennsylvania's version of the prudent investor rule exempts trusts that existed prior to the law's adoption. <sup>184</sup> Second, the sale was not considered necessary to realize the settlor's intent. <sup>185</sup> Describing Hershey's intent, the court explained that his

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<sup>179</sup> Orphans' Ct., p. 6. Community concerns cited by the court included reductions in work force and possible changes of plant location. *Id.*, p. 5.

<sup>180</sup> Orphans' Ct., p. 6.

<sup>181</sup> *Id.*, citing *Pruner's Estate*.

<sup>182</sup> *Id.*, p. 14.

<sup>183</sup> *Id.*, pp. 7, 9.

<sup>184</sup> See 20 Pa. C.S. §7204 (1999). While this provision of Pennsylvania law undoubtedly protects a charitable trustee which decided not to diversify the trust's portfolio, it should not constrain a trustee which believes diversification to be prudent.

<sup>185</sup> In so ruling the court relied in part on the inconsistent testimony of the consultant who recommended the sale. Orphans' Court, p. 11. While claiming his "investment objective [was] to make enough money to support the School's current and prospective education program in perpetuity at a reasonable level of risk," the same consultant admitted on cross examination to have "never known the [School] not to have enough money to do what it needs to do." *Id.*, p. 11. The court went on to cite testimony of the Trust's president from a proceeding two years prior when he claimed that the Trust had more than sufficient funds to

“charitable interests were narrowly restricted. He was concerned for children and his community.”<sup>186</sup>

### **Implications of the *Hershey Trust* case: Limited or Far-reaching?**

Many experts contend that the Attorney General’s arguments, if embraced broadly, would fundamentally alter existing law, hinder the creation of charitable trusts, and force trustees into irreconcilable conflicts.<sup>187</sup> Even if the attorney general’s arguments would not have ultimately been upheld in the Pennsylvania courts, the case certainly may have an impact on charitable trusts in Pennsylvania.<sup>188</sup>

It is difficult to figure out what the real impact will be of the Hershey Trust case, other than that, in Pennsylvania, it has generated legislation which is restrictive for trustees. Will it be limited to its very specific facts or does it have broader reach? What it unquestionably does, however, is raise yet another issue to be considered by charitable fiduciaries (directors of non-profit corporations as well as charitable trustees?) seeking to diversify investment holding.

### **F. Legal Constraints—Conclusion**

Having now reviewed the legal rules and proposed rules applicable to endowment funds of charities as well as certain potential common law constraints on modern portfolio investment, I will now turn to another scheme, this time in the context of charitable corporations, which attempts to characterize and categorize institutional funds in a manner to provide uniform treatment—the financial accounting standards.

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“maintain and perpetually operate the School,” with a “high degree of confidence” for the long term. In its defense, the Trust cited “horrific fluctuations in stock price causing potential losses to the School [Trust] fund” (Orphan’s Court, p. 7).

<sup>186</sup> *Id.* at 9.

<sup>187</sup> Steve Seidenberg, “The Little Ad that Changed Everything.” NATIONAL LAW JOURNAL, September 23, 2002, p. A1.

<sup>188</sup> The Pennsylvania legislature has passed a bill that states that charitable trusts holding controlling interests in certain publicly traded corporations (received as an asset from the trust settlor) must notify the state Attorney General 60 days before executing a change in control of the corporation and provide 30 days notice to the corporation’s employees located in Pennsylvania. 20 Pa. C.S. §7203(d)(1). If the attorney general decides to seek judicial review of the action, the fiduciary must show that the sale is “necessary to maintain the economic viability of the corporation and prevent a significant diminution of trust assets or to avoid an impairment of the charitable purpose of the trust.” 20 Pa. C.S. §§7203(d)(2) and (d)(3).

## Part II. – FASB Accounting Rules<sup>189</sup>

### A. General

Beginning in 1993 and as recently as 1999, the Financial Accounting Standards Board (FASB) has promulgated rules intended to establish standards for consistent accounting and reporting practices of non-profit organizations.<sup>190</sup> Prior to the promulgation of these rules, different types of not-for-profit organizations provided financial statements that differed in form and content. For example, many hospitals, trade associations and membership organizations issued statements of financial position and statements of activities (or of revenues and expenses) that reported with respect to the entity as a whole.<sup>191</sup> By contrast, universities, museums, religious organizations and certain other not-for-profit organizations frequently issued financial statements concerning individual fund groups, but not the results for the entity as a whole.<sup>192</sup> FASB, through certain of its Statements of Financial Accounting Standards (SFAS), endeavored to improve financial reporting by making it more relevant, reliable and consistent among organizations. It was thought that this consistency would enable donors, members and creditors to utilize dependable results when comparing the financial statements of non-profits. Further, they would be better equipped to assess an organization's services, its ability to continue providing services, and the performance of its managers. Curiously enough, those explicitly named to be benefited by these presumably clearer financial statements did not include directors of charitable institutions. Whether this was because FASB assumed directors did not need this assistance or whether, more cynically, in the wake of the Savings and Loan Association scandals, those enumerated—donors, members

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<sup>189</sup> An apology is necessary at the outset. I am not an accountant and therefore approach the FASB rules with some trepidation. My experience is that lawyers and accountants think and approach problems very differently. I therefore almost certainly have done some violence in my interpretation of the statements of financial accounting standards discussed in this paper.

<sup>190</sup> These are the Statements of Financial Accounting Standards, Nos. 116, 117, 124 and 136.

<sup>191</sup> See SFAS No. 117, Introduction ¶ 2.

<sup>192</sup> Additionally, as further pointed out in the Introduction to SFAS No. 117, some organizations, but not all, reported cash flow information. Further, voluntary health and welfare organizations generally issued statements reporting expenses by functional classification and by natural classification, but most other not-for-profit organizations did not do so.

and creditors—were more likely to initiate litigation because of inaccurate financial statements, is not clear.

The four statements discussed below that are applicable to not-for-profit organizations are SFAS Nos. 116, 117, 124, and 136. SFAS No. 116 provides rules for accounting for contributions received and made by organizations. SFAS No. 117 establishes standards for general purpose external financial statements provided by not-for-profit organizations. These two statements were promulgated in 1993. SFAS No. 124, promulgated in 1995, provides rules for accounting for certain investments by not-for-profit organizations. Finally, SFAS No. 136, promulgated in 1999, establishes standards for reporting charitable assets held by one organization on behalf of another.

Not-for-profit organization is defined in SFAS Nos. 116 and 117 as:

An entity that possesses the following characteristics that distinguish it from a business enterprise: (a) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (b) operating purposes other than to provide goods or services at a profit, and (c) absence of ownership interests like those of business enterprises. Not-for-profit organizations have those characteristics in varying degrees. Organizations that clearly fall outside this definition include all investor-owned enterprises and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans.<sup>193</sup>

Because of the importance of certain terms to the accounting statements of not-for-profit organizations, the following definitions that form the primary classificatory regime for assets held by not-for-profit organizations are quoted below. These concepts revolve around donor restrictions and the definitions do not reflect any legal restrictions which may be imposed by state law.

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<sup>193</sup> Concepts Statement 4, ¶¶ 6, 7. From this definition, it would appear that these Statements were intended to be applicable to charitable organizations organized in either trust or in corporate form. However, SFAS No. 136 specifically mentions its applicability to "Not-for-Profit Organization[s] or Charitable Trust[s]." SFAS No. 124 does not define the term "not-for-profit organization," but generally refers back to SFAS No. 117.

- **Permanent restriction**

A donor-imposed restriction that stipulates that resources be maintained permanently but permits the organization to use up or expend part or all of the income (or other economic benefits) derived from the donated assets.

- **Permanently restricted net assets**

The part of the net assets of a not-for-profit organization resulting (a) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization, (b) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) from reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations. . . .

- **Temporary restriction**

A donor-imposed restriction that permits the donee organization to use up or expend the donated assets as specified and is satisfied either by the passage of time or by actions of the organization.

- **Temporarily restricted net assets**

The part of the net assets of a not-for-profit organization resulting (a) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations, (b) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) from reclassifications to (or from) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations. . . .

- **Unrestricted net assets**

The part of the net assets of a not-for-profit organization that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations. . . .<sup>194</sup>

With these terms as the backdrop for the accounting rules, I now turn to the specific rules. In the following discussion, only those rules relating to the general themes of this paper will be discussed.

## **B. SFAS No. 116 – Accounting for Contributions Made and Contributions Received**

SFAS No. 116, *Accounting for Contributions Received and Contributions Made*, was released in 1993. It created an uproar in the charitable community because it requires charitable organizations to include pledges on its financial statements. Charities feared that their financial statements would make them look "richer" than they in fact were, thereby perhaps discouraging donors' contributions and might require them to pursue a donor—to the point of suing the donor—if the donor did not satisfy the pledge.

Though it is most often applied to non-profits, SFAS No. 116 in fact impacts any organization making or receiving contributions, including for-profit enterprises. It stipulates how promises to give and contributions made should appear on financial statements. Generally, it states that contributions received should be listed as gains in the period received and measured at fair value.<sup>195</sup> Contributions to an organization that are conditional should not be recognized until the condition is substantially met, unless the chance of failing to fulfill the condition is remote. There are exceptions to these general rules for certain contributions of services, as well as for contributions of art and historical treasures.<sup>196</sup>

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<sup>194</sup> SFAS No. 116 209, "Glossary" at Appendix D.

<sup>195</sup> SFAS No. 116, ¶8. Similarly, contributions made should be listed as expenses in the period they are given, either as decreases of assets, or increases in liabilities, and should be measured at their fair value. SFAS No. 116, ¶18.

<sup>196</sup> SFAS No. 116, ¶9. Contributions of services to an organization need to be recognized on its financial statements only if the services (a) create or enhance nonfinancial assets, or (b) require special skills, are provided by people with those skills, and would ordinarily be paid for if not given by donation. Services that fall into the second category and that must be listed include those provided by accountants, electricians,



When assets are contributed to a not-for-profit organization, the organization is required to distinguish amongst those gifts subject to permanent restrictions, those subject to temporary restrictions and those subject to no restrictions.<sup>197</sup> Each of these categories of contributed assets increases the organization's permanently restricted net assets, temporarily restricted net assets, or unrestricted net assets, respectively.<sup>198</sup>

Contributions with donor-imposed restrictions may be reported as unrestricted support if the organization meets those restrictions in the same reporting period as the gift was made (and the organization consistently reports in this manner and discloses the policy).<sup>199</sup> An organization that receives an unconditional promise of a gift with payments due in future periods generally must report such amounts as temporarily restricted in the period in which the promise is made, unless the donor clearly intended the gifted amounts to be used to support current period activities.<sup>200</sup> Presumably the same rule applies (i.e., recording donor-restricted pledges in the temporarily restricted category) even if the asset pledged will constitute an endowment fund asset. If that is correct, then I would expect that when the gift does come in, an amount equal to the value of the endowment gift would shift from the temporarily to the permanently restricted category. SFAS No. 116 does not specifically address this.

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lawyers, nurses and teachers. SFAS No. 116, ¶ 9. Entities receiving reportable services should describe the programs for which the services were used, including the character and degree of the services contributed and the amount recognized as revenues for the period. SFAS No. 116, ¶ 10. Artwork, historical treasures and similar assets are also subject to specific rules under this SFAS. SFAS No. 116, 11. Unless an organization capitalizes its collection of these assets, upon contribution they generally do not need to be recognized and reported as revenue on the organization's statement of revenues, expenses, gains and losses if the assets are held for education, research or display as part of a public service, are protected and preserved, and are subject to an organizational policy requiring that, if the assets are sold, the proceeds will be used to purchase other like assets. SFAS No. 116, ¶¶ 11, 13. If these requirements are met, instead of reporting these assets on statements of revenues, expenses, gains and losses, they should be reported separately. The costs of purchased collection items and proceeds from sold collection items should be reflected as a decrease or increase, respectively, in the appropriate class of net assets. Proceeds from insurance recoveries with respect to art should also be reflected. Further, collections should be described, with accounting policies and stewardship policies for the collections described as well. Items de-accessioned should either be described or their fair value disclosed. Finally, the disclosures required should be referred to in a line item on the face of the financial statement.

<sup>197</sup> SFAS No. 116 ¶ 14.

<sup>198</sup> *Id.*

<sup>199</sup> SFAS No. 116 ¶ 14.

<sup>200</sup> SFAS No. 116 ¶ 15. See also Malvern J. Gross, Jr., Richard F. Larkin & John H. McCarthy, *Financial and Accounting Guide for Not-for-Profit Organizations*, PriceWaterhouseCoopers at p. 162 (6<sup>th</sup> ed. 2000).

SFAS No. 116 also includes an important rule regarding the expiration of donor-imposed restrictions. Generally, an organization must recognize the expiration of a donor-imposed restriction on a contribution in the period in which the restriction expires, either as a result of the elapse of time, where the restriction was time-based, or "when the stipulated purpose for which the resource was restricted has been fulfilled, or both."<sup>201</sup> It does so by shifting assets amongst permanently, temporarily and unrestricted assets. For example if a gift establishing an endowment fund restricts expenditure of the appreciation of the fund for a term of years following the date of the gift and thereafter the appreciation is available for general organizational purposes, the appreciation would no longer appear as a temporarily restricted asset and would appear as unrestricted in the year in which the restriction expires. SFAS No. 116 goes on to state that "if an expense is incurred for a purpose for which both unrestricted and temporarily restricted net assets are available, a donor-imposed restriction is fulfilled to the extent of the expense incurred unless the expense is for a purpose that is directly attributable to another specific external source of revenue" (e.g., if the expense is directly attributable to and reimbursed by another organization, as in the case of a government grant).<sup>202</sup>

Under this rule, if an organization has identified assets that are restricted as to their use for a specific purpose, and if operating income is expended on such purpose, a like amount of those restricted assets become unrestricted. For example, if an organization holds \$1 million in endowed scholarship funds, which generates appreciation and income of \$100,000, and the organization expends \$150,000 for scholarship aid in a particular year from its current operating funds, the accounting treatment is as follows. The \$1 million endowment appears as permanently restricted. The \$100,000 in appreciation and income, which would have been classified as temporarily restricted, is reclassified as unrestricted assets, and unrestricted assets (which would include current operating funds) would be reduced by \$50,000. While this rule makes some logical sense, there does not seem to be any strict legal basis for this concept. It was intended to prevent organizations

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<sup>201</sup> SFAS No. 116 ¶ 17.

<sup>202</sup> SFAS No. 116 ¶ 17.

from hoarding restricted assets and thereby showing larger amounts of restricted assets on their balance sheets.<sup>203</sup>

### **C. SFAS No. 117 – Financial Statements of Not-for-Profit Organizations**

SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*, was issued and operates in conjunction with SFAS No. 116. Unlike SFAS No. 116, SFAS No. 117 applies only to non-profit organizations. Resolving traditional discrepancies across different kinds of not-for-profit corporations in their reporting on either the organization as a whole on the one hand, or on specific components of the organization (such as fund by fund reporting) on the other, SFAS No. 117 requires that financial statements focus on the organization as a whole. In deciding to require aggregate entity information, FASB concluded that such reporting "facilitates an overall understanding of [an organization's] financial position, results of . . . operations, and . . . cash flows."<sup>204</sup>

SFAS No. 117 says that the stated purpose of the financial statements of an organization is to provide relevant information to "donors, members, creditors, and others who provide resources to not-for-profit organizations" concerning:

- a. The amount and nature of an organization's assets, liabilities, and net assets
- b. The effects of transactions and other events and circumstances that change the amount and nature of net assets
- c. The amount and kinds of inflows and outflows of economic resources during a period and the relation between the inflows and outflows

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<sup>203</sup> According to John McCarthy of PriceWaterhouseCoopers, because of an interpretation by the Massachusetts Attorney General's Office, the accounting treatment of this transaction for a Massachusetts organization will differ. The Massachusetts Attorney General interprets UMIFA as not requiring the freeing up of restricted funds because of the expenditure of other funds for a restricted purpose. Thus, in the example above, the \$100,000 of income and appreciation would remain classified as temporarily restricted and unrestricted assets (which include current operating funds) would be reduced by the full amount of the \$150,000 expenditure. Further, according to Mr. McCarthy, both Maine and New Hampshire also follow the Massachusetts interpretation

<sup>204</sup> SFAS No. 117, App. B, ¶72.

d. How an organization obtains and spends cash, its borrowing and repayment of borrowing, and other factors that may affect its liquidity

e. The service efforts of an organization.<sup>205</sup>

SFAS No. 117 requires at least three sections on a financial statement: statement of financial position, statement of activities and statement of cash flows.<sup>206</sup> In the statement of financial position, the organization must report its total assets and liabilities and its net assets.<sup>207</sup> Further, its assets also must be divided into the three categories of funds explained in Statement 116: namely, permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets.<sup>208</sup> The statement of activities should include a report of the change in overall net assets as well as the change in the three categories of funds since the prior period.<sup>209</sup>

Specific rules apply to voluntary health and welfare organizations. These organizations must provide a statement of functional expenses with both functional and natural classifications.<sup>210</sup> Other organizations, by contrast, need list only functional expenses.<sup>211</sup> Natural classifications describe what the actual expense was paid for, such as rent, utilities, salaries and professional fees. Functional classifications are by program, service or activity. For example, a hospital might separate expenses for different departments, research, a clinic and public education. Each of these programs would consist of expenses from several different natural classifications.

Finally, SFAS No. 117 amends SFAS No. 95, the Statement governing preparation of an organization's statement of its cash flows, so that those rules also apply to not-for-profit organizations.<sup>212</sup> Accordingly, a not-for-profit organization's statement of cash flows is prepared similarly to the cash flow statement prepared by a for-profit corporation and shows the organization's cash receipts and cash payments during the accounting period.

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<sup>205</sup> SFAS No. 117, ¶¶4, 5.

<sup>206</sup> SFAS No. 117, ¶6.

<sup>207</sup> SFAS No. 117, ¶9.

<sup>208</sup> SFAS No. 117, ¶13.

<sup>209</sup> SFAS No. 117, ¶¶17, 19.

<sup>210</sup> SFAS No. 117, ¶26.

<sup>211</sup> *Id.*

<sup>212</sup> See SFAS No. 117, ¶¶29, 30.

It is important to note that SFAS No. 117 does not stipulate when to release financial statements or how to measure items such as assets, liabilities and net assets, but suggests the organization follow general business practice.<sup>213</sup> It is possible, however, to successfully meet the standard in many different ways. It is also acceptable to add additional classifications to the statement of activities, perhaps highlighting funds that are operating and non-operating, or mere pledges to give. In its comments to the statement, FASB expresses its hope that the "broad general standards" laid out in the rule will allow different non-profits to exercise their judgment, "within certain parameters," to present their financial information in the format they find most appropriate.<sup>214</sup>

**D. SFAS No. 124 – Accounting for Certain Investments Held by Not-for-Profit Organizations**

SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, was promulgated in 1995 in order to provide rules for consistent reporting of gains and losses on endowment fund investments. This statement requires the annual reporting of endowment fund investments at their fair market value for all debt securities and any equity security with a fair market value that is readily determinable.<sup>215</sup> This "mark to market" concept had not previously been mandated for non-profits and was new to many organizations. Gains on endowment fund investments—i.e., endowment fund appreciation—increase temporarily restricted assets (if there is a use-related restriction on fund expenditure) or unrestricted net assets, unless the appreciation is restricted from expenditure pursuant to state law or a specific donor-imposed restriction (e.g., if a donor specifies that appreciation may not be expanded).<sup>216</sup>

Losses on endowment fund investments first reduce temporarily restricted assets and any remaining loss in excess of temporarily restricted assets reduces unrestricted net assets.<sup>217</sup> SFAS No. 124 does not state that excess losses beyond the organization's unrestricted net assets reduce permanently restricted assets. As such, it appears that any

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<sup>213</sup> SFAS No. 117, ¶8.

<sup>214</sup> SFAS No. 117, App. B, ¶¶47, 48.

<sup>215</sup> SFAS No. 124 ¶ 7.

<sup>216</sup> SFAS No. 124 ¶ 11.

<sup>217</sup> SFAS No. 124 ¶ 12.

excess losses in this context could lead to a negative balance in the organization's unrestricted assets,<sup>218</sup> while still showing permanently restricted funds on the organization's balance sheet at their full historic dollar value, regardless of their actual value.<sup>219</sup>

**E. SFAS No. 136 – Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others**

SFAS No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, was issued in 1999 to fill gaps left by SFAS No. 116. Paragraph 4 of SFAS No. 116 states that "[t]his Statement does not apply to transfers of assets in which the reporting entity acts as an agent, trustee, or intermediary, rather than as a donor or donee . . .," and discusses the treatment of gifts to an organization acting merely as an agent or intermediary for another organization. It states that amounts held as agent are recorded as amounts held for the other organization.<sup>220</sup> This statement led to confusion among organizations, particularly those organizations which, as a part of their charitable purposes, "solicit[ ] and collect[ ] cash, products or services and distribute[ ] those assets, the return on investment of those assets, or both to other organizations."<sup>221</sup> If paragraph 4 of SFAS No. 116 were interpreted broadly, many or most of the current activities of those organizations would not be treated as contributions made and received. SFAS No. 136 was promulgated to distinguish between contributions where an organization acts as a mere agent with respect to the transfer, such as an organization that facilitates a contribution of earmarked funds from a donor to a donee (a "fiscal agent")<sup>222</sup> and arrangements where an organization is more than a mere agent (e.g., a community trust). Further, SFAS No. 136 explains how transfers like these should be reported in financial statements by the initial transferor of assets (the

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<sup>218</sup> See Simmons, "The Uniform Management of Institutional Funds Act and Its Meaning for Colleges and Universities," supra note 25 at pp. 7-8.

<sup>219</sup> As John McCarthy of PriceWaterhouseCoopers has helpfully pointed out, this approach is conceptually similar to paid in capital and retained earnings (deficit) in the for-profit business context.

<sup>220</sup> SFAS No. 116, ¶¶ 4, 52-54.

<sup>221</sup> SFAS No. 136, ¶1.

<sup>222</sup> An example used in SFAS No. 136 is when an organization acts as an agent by facilitating a contribution of free legal services between a lawyer (the donor) and a person in need of those services (the donee). See SFAS No. 136, fn. 4, citing SFAS No. 116, Ex. 4, ¶180.

donor or the resource provider), the recipient of those assets (the recipient) and the ultimate beneficiary of those assets (the beneficiary). These rules are very complicated.<sup>223</sup>

1. Accounting for Assets Among Recipients and Beneficiaries.

When a recipient receives assets from a donor for a specified beneficiary, the recipient reports the assets as its own if it is “financially interrelated” with the donor/resource provider or the beneficiary. The specified beneficiary does not recognize the contribution as an asset. Further, if the donor explicitly grants unilateral variance power to the recipient, then the fair value of the contribution is listed as an asset of the recipient and not reported as its asset by the beneficiary.<sup>224</sup> Legally, a variance power can be explicitly granted in the gift instrument or through reference to the recipient organization's articles of incorporation or governing instruments; under FASB's rule, the test is whether the donor understood the implications of the variance power.<sup>225</sup>

If the recipient is not financially interrelated to the donor or resource provider on the one hand or the beneficiary on the other, and has no variance power, it still reports the asset on its financial statements, but it also recognizes a commensurate amount of those assets as a liability to the beneficiary.<sup>226</sup> Thus, its net assets are not affected by the asset. Organizations are financially interrelated if two tests are met. First, one of the organizations must have "the ability to influence the operating and financial decisions of the other."<sup>227</sup> Factors showing the ability to influence are: (i) the organizations are affiliates, (ii) one organization has considerable representation on the governing board of the other, (iii) the charter or bylaws of one organization limits its activities to those that are beneficial to the other, and (iv) the organizations have an agreement whereby one can

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<sup>223</sup> It can be questioned whether some of the accountants applying these rules really understand them. And it can certainly be questioned whether the comptroller or financial officer putting together financial statements for interrelated organizations understands them. Finally, with some certainty very few directors of such organizations, and likely donors, creditors and members of those organizations, do not understand what they are being shown on these financial statements.

<sup>224</sup> Edward Jay Beckwith and David L. Marshall, *Community Foundations and Agency Endowments* 23 (Council on Foundations) (2001).

<sup>225</sup> *Id.*

<sup>226</sup> SFAS No. 136, ¶11.

<sup>227</sup> SFAS No. 136, ¶13.

participate in policymaking processes of the other (e.g., organizational priorities and budget and management compensation decisions).<sup>228</sup>

The second part of the test is that one of the organizations must have “an ongoing economic interest in the net assets of the other.” In the case where the beneficiary has an ongoing economic interest in the net assets of the recipient, the value of the beneficiary’s rights to the recipient organization’s assets “increases or decreases as a result of the investment, fundraising, operating and other activities of the recipient organization.”<sup>229</sup>

Generally foundations existing to raise or invest assets for a beneficiary (or group of affiliates) are considered financially interrelated and the recipient organization would recognize a contribution from a donor as an asset but would not report a commensurate amount as a liability to the beneficiary, and thus the contribution would increase its overall net assets. Similarly, a supporting organization which is related through some control mechanism to its supported organization will also be considered financially interrelated, and the supported organization would recognize a contribution from a donor as an asset without recognizing a commensurate liability.

If a recipient organization that has a variance power does not exercise that power and gives the contribution to the specified beneficiary, it becomes a donor. Similarly, if a beneficiary has an unconditional right to some or all cash flows from a charitable trust or other particular asset pool, the beneficiary should use a valuation technique such as the present value of the estimated expected future cash flows to recognize the interest.

## 2. Accounting for Transfers Between Resource Providers and Recipients.

FASB No. 136 contains specific rules for accounting for transfers of assets to recipient organizations where the transfer is not a contribution. This situation can arise when the following conditions are present:

1. the transferor has a unilateral right to redirect the use of the assets;
2. the transferor made a conditional promise to give, or the transfer is revocable or repayable in another way;
3. the transferor controls the recipient organization and specifies an unaffiliated beneficiary; or

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<sup>228</sup> SFAS No. 136, ¶13b.

<sup>229</sup> *Id.*



4. the transferor specifies itself or its affiliate as the beneficiary and the transfer is not an equity transfer.<sup>230</sup>

In this situation, the transferor is called a “resource provider,” and accounts for the assets as its own. The recipient organization accounts for the assets as a liability. Note that in number (4) above, even if variance power is granted to the recipient organization, because the resource provider is specifying itself or its affiliate as the beneficiary, the gift is not a contribution because it is considered reciprocal. Instead, the recipient organization should recognize a liability for the beneficiary.<sup>231</sup> FASB No. 136 also contains disclosure rules in the event that a not-for-profit organization transfers assets to a recipient naming itself or its affiliate as the beneficiary.<sup>232</sup>

Finally, SFAS No. 136 mandates that if not-for-profits disclose a ratio of fundraising expenses to amounts raised in financial statements, it must also explain how the ratio is determined.

### **Part III. Limitations in Accounting Standards and Interaction between Accounting Standards and Statutory Rules**

Boards of directors of a not-for-profit corporation are responsible for overseeing the financial management of the entity and for its financial health. Part of this duty entails not only approving budgets but also managing the organization's investments. Boards of most charitable organizations subscribe to modern portfolio theory in the management of their organization's investment portfolios. Given that under UMIFA there are certain legal constraints on the expenditure of endowment funds, i.e., historic dollar value must be preserved to the extent possible, how should boards operate?

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<sup>230</sup> SFAS No. 136, ¶17. A transfer is an "equity transaction" if (i) the resource provider specifies itself or its affiliate as the beneficiary, (ii) the resource provider and the recipient organization are financially interrelated, and (iii) neither the resource provider nor its affiliate expects payment of the transferred assets (although payment of investment return on those assets may be expected).

<sup>231</sup> Edward Jay Beckwith and David L. Marshall, *Community Foundations and Agency Endowments* 25 (Council on Foundations) (2001). The impact of this provision no doubt is primarily on community trusts.

<sup>232</sup> In this event, the organization must disclose: (i) the identity of the recipient organization, (ii) whether variance power was granted to the recipient organization and the terms of the variance, (iii) the terms under which amounts are to be distributed to the resource provider (or its affiliate), and (iv) the aggregate amount recognized in the financial statement for those transfers and whether that amount is recorded as an interest in the net assets of the recipient organization or as another kind of asset (e.g., a beneficial interest in assets held by others or a refundable advance). SFAS No. 136, ¶19

As a corollary to modern portfolio theory, the boards of most organizations have adopted a policy, which is, or should be, reviewed from time to time (from the standpoint of prudence) regarding the amount of the annual draw down from its investment assets. This policy permits a percentage of the organization's investment portfolio (both income and appreciation) to be expended annually, and is applied generally against all the funds held in the portfolio -- each endowment fund, each quasi-endowment fund, and unrestricted assets. While most boards have a general understanding that those investment assets comprise both endowment funds as well as unrestricted funds, it is not clear that their understanding extends much further. It is also fair to say, I think, that most have little or no knowledge of the UMIFA rule regarding the requirement not to spend down below the historic dollar value of an endowment fund.<sup>233</sup> Where a particular endowment fund is below its historic dollar value due to market deterioration, the spend rate percentage (at least that portion in excess of the income generated by assets attributable to the endowment fund) may not be levied against that endowment fund, and must either be foregone or levied against other funds (either quasi-endowment or unrestricted funds or other endowment funds which are above their respective historic dollar values). The need, therefore, for education of boards of directors regarding the legal constraints found in UMIFA on endowment funds is paramount. These range from the need for an endowment fund by endowment fund analysis, to the understanding of the historic dollar value concept.

Starting with the premise that the legal rules are not well understood, and even when understood, their applicability to funds in the organization's investment pool is not understood, either by directors, or those who review balance sheets, do the current FASB rules assist directors in doing their jobs? On several fronts, I think they do not.

The promulgation of standard accounting rules for charitable organizations and for accounting for various kinds of funds and for contributions received by organizations, and inter-organizations, is laudable. Consistency across various types organizations in the

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<sup>233</sup> Given the current prolonged downturn in the market, this may be an overstatement. Many boards, through unfortunate experiences in the last several years, have become aware of this rule.

charitable community should increase the accountability of charitable organizations to the public at large.

However, some aspects of the rules promulgated by FASB actually serve to hinder the goal of clarity. Further, the rules are at times at odds (or at least their application is at odds) with the legal rules applicable to charitable asset maintenance. The extent to which the accounting rules only serve to obfuscate has become increasingly troubling in the current economic climate when many organizations and their boards of directors are urgently in search of cash for maintaining programs and for operations. Some of these issues are described below.

#### **A. Entity v. Fund-by-Fund Reporting**

Historically, certain not-for-profit organizations reported with respect to the entity as a whole. Others reported solely with respect to individual fund groups. In choosing a reporting method for not-for-profits, FASB opted for the former: aggregate reporting with respect to the entity as a whole. FASB chose this method in that it believed that "aggregated information about an entity as a whole facilitates an overall understanding of its financial position, results of its operations, and its cash flows."<sup>234</sup> The Board further stated that, "reporting certain basic totals, such as total assets, liabilities, net assets, change in net assets, cash and cash equivalents, and change in cash and cash equivalents, will improve the understandability, usefulness, and completeness of financial reporting by not-for-profit organizations."<sup>235</sup> Moreover, financial statements by their very nature call for aggregated reporting.

It is certainly true that aggregate reporting of these aspects of a not-for-profit organization can be very useful in assessing the organization's financial condition. This aspect of reporting follows the reporting methods generally applicable to for-profit corporations. However, not-for-profit organizations are, of course, not the same as for-profit corporations, and it reduces the usefulness of financial statements to report solely on an aggregate basis. While reporting on a disaggregated basis would be impractical,

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<sup>234</sup> SFAS No. 117 ¶72.

<sup>235</sup> *Id.*

there are steps that could be taken to provide greater transparency to readers of financial statements.

This is particularly the case with respect to the reporting of an organization's endowment funds. An organization that accepts an endowment fund contribution to be expended on a specific charitable purpose has essentially legally obligated itself to not only preserve those funds, but also use those funds for specific donor-imposed purposes. UMIFA speaks about endowment funds in the singular,<sup>236</sup> and there is strong suggestion in the language of UMIFA that endowment funds should be considered on a fund-by-fund, rather than an aggregate, basis. The New York Attorney General's office has issued a statement that takes this position.<sup>237</sup> The directors are charged not to expend below the historic dollar value of an organization's endowment funds, and this means a fund-by-fund analysis. Yet under SFAS No. 117 all endowment funds are shown in the aggregate as "permanently restricted" or "temporarily restricted," and the permanently restricted amount is the aggregate of the historic dollar value of all endowment funds.<sup>238</sup> Appreciation on those funds is shown either in the temporarily restricted column (for use-restricted funds) or in the unrestricted column (for general purpose endowment funds). Moreover, any depreciation below the historic dollar value of the permanently restricted endowment funds does not reduce the amount shown on the balance sheet as permanently restricted, but, pursuant to SFAS No. 124, serves only to reduce first temporarily restricted funds, and then unrestricted funds. Therefore, a director reviewing the organization's financial statements has no idea whether, when the annual take down rate is applied against the endowment funds, it is reducing any of them below the historic dollar value. Nor is it obvious whether such a decrease is due to over-spending or to depreciation in certain (particularly recently-endowed) endowment funds because of a down-turn in the market.

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<sup>236</sup> Section 2 of UMIFA indicates that determinations regarding expenditure of appreciation is made on an endowment fund-by-endowment fund basis. Further, the definitions of "institutional fund," "endowment fund," "historic dollar value," and "gift instrument" are all in the singular. UMIFA §§ 1(2), 1(3), 1(5), 1(6).

<sup>237</sup> See "New York State Attorney General Elliot Spitzer Advises Not-for-Profit Corporations on the Appropriate of Endowment Fund Appreciation," ("Attorney General Advice") at [www.oag.state.ny.us/charities/endowment.pdf](http://www.oag.state.ny.us/charities/endowment.pdf).

<sup>238</sup> Further, the Board discussion of SFAS No. 124 states that for perpetual endowment funds, "permanently restricted net assets should equal the historic value of the fund." SFAS No. 124, ¶ 73.

If organizations were required to report both on an aggregate basis generally, but also on a fund-by-fund basis with respect to their endowment funds, financial statements would be much more informative to boards of directors in their efforts to determine not only the financial health of the organization, but also whether the organization is in compliance with the endowment fund maintenance rules applicable to it.<sup>239</sup> It may also be that we should not expect financial statements -- by their very nature a formal and limited exposition of an organization's financial status -- to provide this information.<sup>240</sup>

## **B. Interaction Between Statutory Rules and FASB**

### **1. Interactions Between State Statutory Rules and FASB**

Because of the fluctuation amongst the states in the laws governing endowment fund maintenance, at times FASB's goal of consistency in accounting across all not-for-profit organizations can be difficult to achieve. For one thing, not all states have adopted UMIFA. For those that have adopted a UMIFA-based statute, not all of those states have adopted its terms verbatim. Several states in fact have incorporated significant substantive changes into their version of the uniform statute. These variations amongst the states can lead to complications in the interaction between a particular state's statutory rules and FASB, particularly in determining which portion of an organization's assets are shown on financial statements as restricted.

For example, an organization must characterize its assets as permanently restricted, temporarily restricted, or unrestricted. Permanently restricted assets are those assets that may never be expended. The definition of permanently restricted assets refers only to *donor imposed* restrictions (see above). Thus, generally, only the historic dollar value of an endowment fund would be classified on an organization's balance sheets as permanently

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<sup>239</sup> The notes to financial statements may be the place that these issues should be addressed. In my experience, there is very little uniformity about what is covered in the notes or how it is explicated. Moreover, I have real concerns as to whether financial officers who prepare the financial statements and the notes, accountants who review them and the board which, hopefully, reads them really understand the rules.

<sup>240</sup> In New York, N-PCL section 513(b) requires the treasurer of a not-for-profit corporation to report annually to the board of directors (unless there are members, in which case, to the members) on a fund-by-fund basis regarding the assets received for specific purposes. This requirement, which is discussed further below, is probably more honored in the breach than the observance.

restricted. In fact, the Board comments to SFAS No. 124 clearly state that, "permanently restricted net assets should equal the historic value of the fund."<sup>241</sup> My understanding is that most organizations report only this portion of an endowment fund as permanently restricted. It is not clear then how amounts that are legally restricted from expenditure should be reported.

New York, for example, made important substantive changes in adopting a UMIFA-based statute. While UMIFA permits the appropriation for expenditure of net appreciation, realized or unrealized, with respect to endowment fund assets over the historic dollar value of that fund, the New York version only allows for the appropriation of unrealized appreciation with respect to readily marketable assets.<sup>242</sup> Appreciation on endowment fund assets invested in non-readily marketable securities may not be appropriated until realized.<sup>243</sup> This is a legal requirement, over and above any donor restrictions. This is an important distinction because many non-readily marketable securities are term securities that may not be sold for a several-year period without incurring potentially significant penalties. It is misleading for a board of directors to consider appreciation on these assets as unrestricted and available for use.

How then should the unrealized appreciation on non-readily marketable securities be reported on a New York not-for-profit corporation's balance sheets? Because the restriction on the expenditure of this appreciation does not derive from the terms of the gift instrument creating the endowment (SFAS No. 116 definition of permanently restricted assets), an argument can be made that such appreciation should be treated as unrestricted assets under the literal definition of permanently restricted assets.

However, such a method of reporting may not be in accordance with the proper reporting method as described by FASB. In the "Basis for Conclusions" section of SFAS No. 117, the Board expressed its belief that legal restrictions on expenditure of an asset could require reporting that asset as permanently restricted and that varying laws amongst the states must be considered. As the Board stated, "if the law of the relevant jurisdiction, as interpreted by an organization's governing board, places permanent restrictions on some

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<sup>241</sup> SFAS No. 124, ¶ 73.

<sup>242</sup> New York N-PCL § 513(c).

<sup>243</sup> *Id.*

part of the net appreciation, that amount should be reported as permanently restricted net assets in the organization's financial statements."<sup>244</sup>

Perhaps the most appropriate treatment of unrealized appreciation on nonreadily marketable assets is to treat it as temporarily restricted – temporarily because a board can decide to liquidate the assets and thereby free up the appreciation, but, until such action is taken, it is restricted by law from expenditure.

My limited experience with the financial statements of New York not-for-profit corporations (blessed by their outside accounting firms) is that they report their unrealized appreciation with respect to the illiquid securities in their endowment funds as unrestricted, even though the organization is legally precluded from spending this appreciation until they are realized. This seriously creates confusion for those reading the organization's financial statements who may assume that these "unrestricted" assets are currently available for expenditure. A board of directors of an entity which has substantial holdings of "alternative investments" (which are generally not readily marketable securities) in the entity's endowment funds may easily violate N-PCL Section 513(c) without any idea it is doing so by applying the entity's takedown rate against the endowment funds invested in these illiquid securities.

This situation could also be easily rectified by showing as temporarily restricted, two categories—one as donor restricted (limited as to time or use by the donor), and the other as statutorily restricted (the appreciation attributable to non-readily marketable securities).<sup>245</sup>

The New York UMIFA-based statute discussed above creates confusion in its interaction with FASB in that it increases amounts that may not be expended (i.e.,

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<sup>244</sup> SFAS No. 117, ¶129. This view is supported by language in SFAS No. 124. In providing rules for reporting unrealized gains and losses on endowment fund investments, SFAS No. 124 states that gains and losses increase or decrease "unrestricted assets unless their use is temporarily or permanently restricted by explicit donor stipulations or by law." SFAS No. 124, ¶8. SFAS No. 124 repeats this in paragraph 11: "Unless gains and losses are temporarily or permanently restricted by a donor's explicit stipulation or by a law that extends a donor's restriction to them, gains and losses on investments of a donor-restricted fund are changes in unrestricted net assets." This Statement does not elaborate whether a law that limits expenditure of appreciation could be considered a "law that extends a donor's restriction." It would be useful if FASB could clarify this.

<sup>245</sup> Again, this could also be covered in the notes to the financial statements. But, again, I am skeptical as to how many of the interested parties – especially the directors – read the notes to the financial statements. In addition, many financial officers are not aware of this restriction.

unrealized appreciation on illiquid assets). Pennsylvania law, by contrast, could result in confusion in that it increases amounts that *can* be expended. Pennsylvania is one of the handful of states that has not adopted a UMIFA-based statute. Under Pennsylvania law, organizations whose boards of directors adopt a total return policy may make a specific election in writing in order to treat between two and seven percent of the value of the organization's assets as "income" available for expenditure.<sup>246</sup>

An organization that has made this election can legally spend below historic dollar value when its spend rate results in treatment of amounts as income that are in excess of current and prior earnings and appreciation on investment assets. In fact, in such an event, the organization appears to be *required* to spend in accordance with the spend rate, notwithstanding that such expenditure would bring the fund below historic dollar value. As pointed out by PriceWaterhouseCoopers', Jack McCarthy, this expenditure is not contemplated by FASB.<sup>247</sup> SFAS No. 124 deals with accounting for *losses* on investment assets, but not decreases due to expenditure. Because the Pennsylvania statute is intended to even out spending with an eye to long-term preservation of the original value of the endowment fund, Mr. McCarthy suggests it would be anomalous to account for these distributions as a reduction in permanently restricted assets.<sup>248</sup> In fact, accounting for these expenditures as a reduction in permanently restricted assets would not accord with FASB's statements that permanently restricted assets should equal historic dollar value.<sup>249</sup>

Another result of the Pennsylvania scheme is that the organization would be legally precluded from expending amounts earned by, and appreciation on, fund assets in excess of the percentage spend rate. Under UMIFA, these amounts would be available for expenditure and classified as unrestricted (or temporarily restricted in the case of a use-restricted fund). Since these assets are not legally expendable under Pennsylvania law, it would appear that they should be treated as temporarily restricted assets since they are restricted pursuant to state law. I would not be surprised to learn that many organizations

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<sup>246</sup> 15 Pa. C.S. § 5548(c).

<sup>247</sup> Jack McCarthy, "Pennsylvania Accounting for Endowment Spending – Notes" (Sept. 2, 2003), on file with author.

<sup>248</sup> *Id.*

<sup>249</sup> SFAS No. 124, ¶73.



in Pennsylvania instead classify these assets as unrestricted, relying on the definition of "temporarily restricted" assets, which refers only to donor-imposed, and not state law, restrictions.<sup>250</sup>

2. When UMIFA Leaves Things to the Discretion of the Board.

UMIFA leaves certain choices to the discretion of boards of directors. This also can lead to confusion in the proper reporting of assets as permanently restricted. For example, in meeting its standard of care with respect to the expenditure of appreciation, UMIFA requires consideration of, among other things, the long- and short-term needs of the organization, anticipated financial requirements, and price level trends. Many interpret the standard of care to require maintenance of an inflationary reserve with respect to each endowment fund in order to preserve the fund's original purchasing power. In New York, the Attorney General interprets the New York version of UMIFA to require the maintenance of an inflation reserve.<sup>251</sup>

An organization that reserves a portion of its endowment fund assets as not available for appropriation for expenditure because it believes that it would not be prudent to spend those assets may consider this reserve as legally restricted from expenditure. Nonetheless, the SFAS definition of permanently restricted assets does not require and in fact does not permit an inflation reserve be recorded as permanently restricted. A FASB Staff Announcement on SFAS Nos. 117 and 124 specifically states that the FASB staff does not believe that an inflation reserve maintained in accordance with the organization's standard of ordinary business care and prudence is a specific enough restriction so as to lead to the classification of such reserve as either temporarily or permanently restricted.<sup>252</sup> This again generates confusion for a board of directors reviewing an organization's

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<sup>250</sup> Jack McCarthy suggests that in reducing endowment funds of a Pennsylvania organization as a result of investment losses, those losses should first reduce temporarily restricted assets other than those assets that are classified as temporarily restricted because they represent earnings and appreciation above the spend rate. Further losses, if any, should reduce the temporarily restricted assets that represent earnings and appreciation above the spend rate. Further losses, if any, should reduce unrestricted assets. See McCarthy, "Pennsylvania Accounting for Endowment Spending – Notes," supra note 247.

<sup>251</sup> See New York Attorney General Advice posted at [www.org.state.ny.us/charities/news/endowment.pdf](http://www.org.state.ny.us/charities/news/endowment.pdf) (revised July 2003).

<sup>252</sup> See <http://www.nysscpa.org/cpajournal/1996/0696/newsviews/nv5.htm>

financial statements who may assume that the assets listed as permanently restricted include an inflation reserve.

New York organizations do not classify their inflation reserve as restricted.<sup>253</sup> There seems to me to be no reason why this situation again could not be rectified by showing as temporarily restricted, two categories—one as donor restricted (limited as to time or use by the donor), and the other as statutorily restricted (the appreciation on non-readily marketable securities and the reserve against inflation). Or, the statutorily restricted line could become two further subcategories (at least for New York entities) — appreciation on non-readily marketable securities and a reserve against inflation. This approach should be acceptable to FASB, but discussions I had with FASB when SFAS No. 117 was first proposed made it clear that FASB would not accept the treatment of two categories of statutorily mandated (in the case of appreciation on non-readily marketable assets) and statutorily suggested (as in the case of a prudent setting aside of an inflation reserve) assets as two categories of temporarily restricted assets.

### **C. SFAS No. 124 – "Permanently Restricted" Assets; Treatment of Losses**

With the required trifurcation of organizational assets into permanently restricted, temporarily restricted and unrestricted categories of assets, permanently restricted assets reflect the historic dollar value of donor restricted funds. The purpose of including this category is to identify those assets that are legally restricted (by the donor) from expenditure. Many readers of financial statements also see permanently restricted assets as evidence of the organization's wealth.<sup>254</sup> A large amount of permanently restricted assets may imply the financial health of a not-for-profit corporation. However, this may at times be misleading. For example, an organization which has "borrowed" from its endowment fund to finance current operations does not have to disclose this "borrowing" by a

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<sup>253</sup> Note that, as discussed above, Rhode Island statutorily requires the upward adjustment of historic dollar value to maintain the fund's purchase power. The Board commentary to FASB No. 117 specifically refers to this substantive law, stating that interpreting and classifying amounts reserved for this purpose as permanently restricted "would be a fair representation." Rhode Island organizations report these amounts as permanently restricted.

<sup>254</sup> Although probably the rating agencies and sophisticated readers would not reach this conclusion.

reduction in the organization's permanently restricted assets. Therefore, the board may be unaware of it.

SFAS No. 124's methodology for reporting gains and losses on endowment fund assets may also lead to confusion in its treatment of permanently restricted assets. SFAS No. 124 requires that endowment funds be shown on financial statements at their current fair market value and includes a waterfall for reducing fund assets when a fund incurs a loss in value during an accounting period. These losses reduce, first, temporarily restricted assets, and once those have been exhausted, reduce unrestricted net assets. However, losses would not normally reduce permanently restricted assets. If losses exceed unrestricted net assets, as they might in an entity whose assets are primarily comprised of endowment funds, the organization's unrestricted net assets could become negative.

An illustration may be helpful. An organization shows \$1,200,000 of permanently restricted assets, representing the historic dollar value of its endowment funds. It also has \$150,000 in temporarily restricted assets, representing appreciation and earnings on the assets in which the \$1,250,000 endowment was invested that is subject to a donor-imposed restriction as to its use, and has \$100,000 in unrestricted assets. If, due to a precipitous decline in the market the investment assets plummet 25%, the assets in which the endowment was invested will have lost \$300,000 in value. In order to account for this loss, the organization does not reduce its permanently restricted assets. Instead, it must first reduce its temporarily restricted assets. Since the loss (\$300,000) exceeds the amount of temporarily restricted assets (\$150,000), the organization must then reduce unrestricted assets with respect to the remaining loss (\$150,000). Since that amount exceeds the amount of the organization's unrestricted assets (\$100,000), the organization must show a negative unrestricted asset balance of (\$50,000).

Although the organization shows a negative unrestricted net asset balance, this would not preclude it from spending the actual assets that made up what was originally shown as its unrestricted assets (e.g., its cash), as SFAS No. 124 notes that it does not require that an institution make whole an endowment fund that has fallen below historic

dollar value.<sup>255</sup> Thus, organizations whose endowment funds have dropped below historic dollar value, still report the whole original amount of their permanently restricted assets (the historic dollar value), even though their funds may not have a value commensurate with the amount of permanently restricted assets reported.

This method is a striking example of FASB's use of aggregate reporting to the detriment of a board of directors who review financial statements in their fiduciary capacity in order to determine whether each endowment fund is in compliance with the law. In fact, this limitation in the current methodology was noted by one of the FASB members charged with drafting FASB No. 124 (and who dissented from the vote to adopt the Statement).<sup>256</sup> This FASB member suggested instead that losses on investments of permanently restricted endowment funds should reduce the net asset classes in which unappropriated net appreciation of the fund is reported, and any additional losses should reduce permanently restricted assets. In other words, if there are losses that reduce the value of an endowment fund below the historic dollar value, those assets are not expendable and all net assets of that fund should be classified as permanently restricted.<sup>257</sup> FASB rejected this method in favor of the one it adopted for practical reasons, primarily due to the fact that under many of the state laws governing endowment funds, and also under UMIFA, there is no consistent definition of the term "the assets of an endowment fund" that are available for appropriation.<sup>258</sup> Different interpretations of that term and of when appreciation is considered to be "appropriated" for expenditure could lead to variations in the manner in which organizations determine which losses are losses of an endowment fund and whether losses can be netted with prior period appreciation.<sup>259</sup>

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<sup>255</sup> See Simmons, "The Uniform Management of Institutional Funds Act and Its Meaning for Colleges and Universities," supra note 25 at 7-8. Simmons notes the practical adverse side effect of an organization being required to report a negative unrestricted net asset balance on its financial statements in terms of attempting to obtain credit and attracting donors, particularly in the case of donors that are not sophisticated readers of financial statements, and argues that the fear of generating a negative balance may cause organizations to favor fixed-income investment securities, which runs counter to modern day investment practices.

<sup>256</sup> SFAS No. 124, Statement of the Board regarding adoption of the Statement.

<sup>257</sup> *Id.*

<sup>258</sup> FASB did add a requirement that entities disclose in their financial statements the amount by which the historic dollar value of an endowment fund exceeds the fair market value of the funds assets. SFAS No. 124, ¶76.

<sup>259</sup> SFAS No. 124, ¶69.

While the concerns FASB raises are valid, it is disappointing that the lack of clarity in the definition of certain terms in UMIFA and state statutes could have such a major impact on financial reporting. The New York Attorney General's office has begun to clarify this ambiguity in New York, stating that once funds are appropriately identified as appropriated for expenditure, they are no longer part of the endowment fund, so that, even if the fund drops below historic dollar value after the funds are appropriated, but before they are actually spent, they are still available for expenditure.<sup>260</sup> The corollary is that if an endowment fund drops below historic dollar value, funds other than current income (and that only if the board believes it is prudent to do so) may not be appropriated. Perhaps the drafters of Revised UMIFA will also provide some clarity in this area.

**D. SFAS No. 136 – Accounting for Assets Amongst Affiliated Organizations**

It is not at all uncommon for several not-for-profit organizations to be closely affiliated. Many organizations perform their functions through several entities, many of which share identical officers, employees and boards of directors. Further, at times, one of the organizations will do a significant amount of the fund raising activity, and will hold endowment fund assets, on behalf of its affiliates. The charters of these corporations often contain broadly drafted purposes clauses allowing for grants or contributions among the related entities in light of their common goals and purposes.

Given this context, it is important that FASB provides rules for consistent reporting of assets held by one organization on behalf of another. Although an organization that holds assets on behalf of another generally must report those assets on its balance sheet, the primary question is whether it also must report a corresponding liability to the ultimate beneficiary.

SFAS No. 136 was promulgated in order to provide such consistency. However, the flexibility that SFAS No. 136 offers may in fact hinder that purpose. Part of the problem has to do with the key term in SFAS No. 136, "financial interrelatedness." If a recipient of an asset from a donor is "financially interrelated" to the ultimate beneficiary of

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<sup>260</sup> See New York Attorney General Advice at [www.oag.state.ny.us/charities/endowment.pdf](http://www.oag.state.ny.us/charities/endowment.pdf)

that asset, the recipient reports that asset as its own. If it is not financially interrelated, although it reports the asset as its own, it must report a corresponding liability to the beneficiary. To be financially related requires a showing of economic interrelatedness and also control. However, this is a subjective test performed by the preparer of the financial statements of the organization. As one commentator has stated, "[a] great deal of judgment is required to decide whether the level of control is high enough to qualify as strong" enough to require the recipient to report the assets as its own.<sup>261</sup>

Considering the importance of whether organizations are financially interrelated to the reporting of these assets, it is surprising that the term is so reliant on a subjective test. Without a bright-line rule, it would be very useful to readers of the financial statements if it were required that financial statements report exactly which affiliates in the organization's judgment are and are not financially interrelated and the impact of these decisions on the organization's statement of assets and liabilities.

#### **Part IV. Conclusions and Where Are We.**

In thinking through the real constraints on boards of directors in trying to implement a policy of total return for their organizations, the statutory legal constraints involve primarily pure endowment funds. Under UMIFA, it appears that each endowment fund must be accounted for separately and under the current version of UMIFA, which has been adopted in most of the states, the historic dollar value must be maintained. When an endowment fund drops below the historic dollar value due to market conditions, it appears that only the actual income which is generated from that fund may be spent (if the board determines it is prudent to do so) and that the organization's normal draw down rate cannot be applied against the fund if to do so would further deplete the fund. This can, given the timing of when endowment funds were created and the recent decline in investment markets, really restrain how a board invests and whether it can apply a draw down rate against all its funds. In addition, in certain states such as New York, where unrealized appreciation on non-readily marketable securities cannot be expended, the

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<sup>261</sup> Gross, Larkin and McCarthy, *Financial and Accounting Guide for Not-for-Profit Organizations*, PriceWaterhouseCoopers at p. 201.

diversity of investments in which an investment committee can invest may be limited by the need for available operating cash. With the emphasis on, and also the success of, many alternative investments, some of the most successful endowments have been invested 50-60-70 percent in alternative investments. Many of these investments would not be considered to be readily marketable, because there are limitations on the ability to pull out funds on short notice. For those organizations incorporated in New York, despite appreciation which has occurred in those funds, the board may not be able to access it. This is often a surprise, particularly given the treatment of that appreciation on the organization's balance sheets, which would make it appear that there is a large amount of unrestricted assets (comprised in actuality by appreciation on these non-readily marketable assets).

Embracing the total return theory, the elimination in the draft Revised UMIFA of the concept of historic dollar value is understandable and is theoretically an appropriate action. Having dealt now with boards of directors under the existing UMIFA, I question whether it will ultimately be a dangerous concept. At least the concept of historic dollar value provides a useful discipline. The various specified factors to be considered by a board as articulated in the Revised UMIFA are certainly important, and many boards may, in fact, actually consider them. However, I think what will happen in practice is that boards will pay lip service to them but whether they will actually be thoughtfully considered is a question. It seems to me a potentially dangerous concept to open up expenditure of what might be considered the "principal" of endowment funds by rationalizing that that expenditure is necessary to get through a hard time in the market or to cover special expenses (which, of course, will be paid for by savings or revenues).

Putting aside these rather fundamental issues, there is also a question of how FASB will deal with endowment funds if the concept of historic dollar value disappears under the Revised UMIFA. The rationale of the FASB rules is that funds are restricted depending on what the donor has said (which ties the hands of the board) regardless of the board's duty to act prudently. Thus, under the current UMIFA and under SFAS No. 117, the historic dollar value of a general endowment fund is treated as permanently restricted, and all appreciation is treated as unrestricted, even though the board may believe it is prudent

to reserve some of the appreciation to maintain the purchase power of the fund. Any decisions left to a board of directors does not affect the classification of endowment funds as permanently or temporarily restricted or unrestricted. If under Revised UMIFA the boards of directors essentially have no firm parameters as to what can be spent and not spent from endowment funds, will FASB have to rethink its approach?

Although a significant portion of the discussion in this paper has been on the interaction between FASB and state laws—primarily UMIFA—governing charitable asset maintenance, perhaps this is a misplaced focus. It may be the case that an organization's financial statements prepared in accordance with FASB guidelines should not be what boards of directors rely on in their efforts to comply with endowment fund maintenance rules. As discussed above, the FASB guidelines were developed to enhance public accountability, and not with an eye to endowment fund maintenance or board governance and responsibility.

In the absence of an ability to rely on financial statements, however, it is not clear what a board of directors may look to in order to adequately monitor the organization's charitable assets in light of applicable law. IRS annual filings, in particular the Forms 990, are not suitable to this task. Although Forms 990 are available for public review, they depict the organization's endowment funds only in the most cursory manner.<sup>262</sup>

Perhaps charitable organizations should be required to report to their boards of directors on an annual basis (or even more frequently) the status of their endowment funds. The organization could outline in a manner that is useful to the board all relevant information regarding the fund, including the historic dollar value of each fund held by the organization, the current value of the fund, restrictions on use of fund assets, the manner in which the fund is invested, any inflation reserve, whether some of the assets constitute assets that were pledged yet have not been received, whether there are any state law restrictions on use of fund assets, whether all or a portion of the fund is held by or for another organization and whether the fund has been borrowed against.

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<sup>262</sup> It is even arguable how useful these forms are for ensuring public accountability of the organization. See Peter Swords, "Form 990 as a Tool for Nonprofit Accountability." Paper presented to NYU School of Law, National Center on Philanthropy and the Law Conference, "Governance of Nonprofit Organizations: Standards and Enforcement" (October 30 and 31, 1997).



New York includes a statutory requirement of this sort. N-PCL § 513(b) states that boards of directors must "cause separate accounts to be kept of such assets separate and apart from the accounts of other assets of the corporation. Unless the terms of the particular gift provide otherwise, the treasurer shall make an annual report to the members (if there be members) or to the governing board (if there be no members) concerning the assets held under this section and the use made of such assets and of the income thereof." In my experience, many New York not-for-profit corporations do not comply with this statutory requirement independently of the preparation of annual accounting statements in accordance with the FASB rules. This may not be enough, as the FASB rules provide for aggregate reporting with respect to an entity as a whole and the New York statute clearly calls for a stand-alone fund-by-fund report of the endowment funds.

Perhaps a clear, statutorily mandated requirement that specifically outlines the factors that need be included in an endowment fund report would be useful. Trying to make the FASB rules harmonious with the legal rules applicable to endowment fund maintenance may be like trying to fit a square peg into a round hole. Perhaps moving away from a reliance on financial statements and toward a separate accounting for endowment funds in a manner that is designed to aid boards of directors in their efforts towards maintaining the endowment funds in compliance with applicable state law would be most helpful.

In addition to changing the FASB rules or devising an alternate means for reporting charitable assets that will be useful to boards of directors, better education of boards and financial officers is essential. With that education will hopefully come better tools to help boards understand the realities they face and responsibilities they assume in managing and investing an organization's assets.