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THE LAW AND LORE OF ENDOWMENT FUNDS. By William L. Cary and Craig B. Bright. New York, New York: Ford Foundation. 1969. 94 pages.

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The Cary-Bright Report[1] on endowment funds is both long overdue and exceptionally timely. For several generations the financial aspect of the world of charitable and educational endowment funds has been dominated by the cautious conservatism of the nineteenth Century, the period during which the larger endowment funds originated. The conditions and approaches have changed dramatically since that time but the thinking of those entrusted with the care of these funds has, more often than not, continued to follow the narrow paths defined by the dictates of the last century. Those dictates stressed the "protective" role of the trustees rather than their responsibility to make the best possible use of the funds entrusted to them. *The Report* is, therefore, long overdue and the light it sheds on the relative absence of legal restrictions on endowment funds is most welcome.

The timeliness of *The Report* is obvious. Coming, as it does, when the Congress is in the process of restructuring the role of foundations and their relations to government and society, it will be of significant value. In years past the legal position of endowment funds has been, at best, only dimly understood and has seldom been examined by the courts. Whatever changes may be promulgated by the Congress, at least *The Report* provides solid legal bench marks for present guidance. Endowed funds, and their affiliated foundations, have become a major segment of the financial world in recent years. Within this orbit is the burgeoning educational composite which in 1968 received in excess of one and one-half billion dollars in non-government support funds, most of which went to increase existing endowment funds. At the university level alone these endowment funds amounted to eleven billion dollars at market value and eight and one-half billion dollars at book value. This two and one-half billion dollar differential, and how it can be most advantageously applied, is the central theme of *The Report*.[2]

The basic problem under observation is the kind and level of restrictions within which trustees of endowment funds are constrained to operate. This, in turn, can be further reduced to the central question of whether trustees can legally expend the "appreciated value" of investments or whether they must retain the principal in its original form and dollar value and expend only the "income earned" (interest, dividends, etc.). The legal guidelines range from the archaic proscription embodied in the Constitution of the State of Montana which reads: "The legislative assembly shall not authorize the investment of

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1. Hereinafter referred to as *The Report.*
2. *See* American Alumni Council 1968-1969 Report on Financial Aid.

trust funds . . . in the bonds or stock of any private corporation,"[3] to a New York statute which espouses the "prudent man" rule: "A membership corporation may invest its funds in such mortgages, bonds, debentures, shares of common and preferred stock and other securities as its directors deem advisable."[4]

The Report had its origin in comments made a few years ago by McGeorge Bundy, President of the Ford Foundation. He noted that there was considerable room for improvement in the investment performance of college and university endowment funds. *The Report* is concerned with only the legal aspect of the formulation of sound investment policy. The question of whether existing law is restrictive, flexible or neutral with respect to educational institutions' handling of their investments is examined at length. Suggestions are offered as to how the law can be used to the advantage of the financial officers and how existing laws might be improved to the benefit of all concerned. In preparing their report, the authors were advised by a committee of eleven distinguished jurists.[5]

The reason for concern with regard to the handling of endowment funds is not that they have been deliberately mishandled but rather that their management has been so cautious that little or no growth has resulted for the benefit of the institutions they serve. In a period when both the price of and the dividends from common stocks have risen at a phenomenal rate, many endowment portfolios have barely kept even. Although these financial managers have remained steadfast to their trust to "safeguard the legacies" under their control, by their failure to respond to the changing conditions in the money markets, they have, through inflation, lost the funds entrusted to them "just as surely as if they were squandered or thrown away. The legacy of tomorrow's students has been sacrificed to fiscal conservatism."[6]

This indictment cannot be leveled at endowment fund managers in general. Many, such as those in charge of funds at Yale, Cornell, California and other universities, have developed innovative plans which have yielded increased financing for both current and future needs. It is the need for immediate income to meet current expenses that has forced most of the decisions away from investments in long-term growth securities. While the mounting costs of education have perhaps narrowed the opportunities for seeking investments with attractive capital gains potential, this is not the only factor in the decision pattern. The fear of charges of "misuse or negligence" in fund management is still a major concern for many. This retarding influence, which has its basis in the legalities of fund management (as understood and misunderstood by the managers), lends

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3. MONT. CONST. art. V, § 37.
4. N.Y. MEM. CORP. LAW § 27 (McKinney Supp. 1969).
5. Eli Whitney Debevoise, New York, New York; Morris M. Doyle, San Francisco, California; Paul Harbrecht, S.J., Washington, D.C.; Stephen H. Hart, Denver, Colorado; Glen A. Lloyd, Chicago, Illinois; Lewis F. Powell, Jr., Richmond, Virginia; H. Chapman Rose, Cleveland, Ohio; Austin Wakeman Scott, Cambridge, Massachusetts; Frederick Sheffield, New York, New York; Alan M. Stroock, New York, New York; and Bethuel M. Webster, New York, New York.
6. P. 5.

additional cogency to *The Cary-Bright Report*. Now, more than at any time in the past, the managers of educational endowment funds must take advantage of every means available to make the most prudent and profitable use of the funds entrusted to them.

The authors point out that one major factor which has tended to lend an overly cautious flavor to endowment fund management is the belief held by many that these funds are always subject to the restrictive laws governing trusts rather than to those governing corporations. Trust law is mainly concerned with protecting the income beneficiary and the remainderman of a trust. Since the interests of these two parties to the trust are antagonistic, the laws controlling the disposition of trust funds must be quite specific and restrictive. The case of the educational endowment is quite different since the income beneficiary, the remainderman and the trustee are one and the same. Trust laws should not, and *generally speaking* do not, apply. The few decided cases indicate that an educational endowment fund is treated as a charitable corporation. In preparing *The Report*, however, the authors examined cases in several states which bear on whether the courts view charitable corporations as subject to trust principles, corporate principles or contract principles. "This examination clearly indicated that the choice of principles depends upon the factual situation presented and upon the result the courts deem socially desirable to attain."[7] Thus, intent and conditions, rather than corporate designations, would appear to be the deciding factors in the disposition of cases involving charitable corporations.

As is the case with other corporations, charitable corporations have several options open with respect to how they may make use of appreciations in value (capital gains) of their endowment portfolios. They may, for example, cash in securities which have grown in value and use the appreciated balance as they choose—for reinvestment, for operating expenses or for other legitimate purposes. In the present inflationary period, however, it would be a violation of the terms of the original endowment if they reinvested only the actual dollar amount which made up the original endowment fund. The value of the dollar in 1969 is not the same as it was in 1959 or 1939. The fund must, therefore, be increased (or retained) by the amount of inflation which has occurred since the time when the funds were first invested. This would protect the intent expressed by most donors that the fund entrusted be kept "intact" and that only the income therefrom be spent. While it is true that modern interpretations designate appreciation as income, prudent, good management practice would dictate that the factor of inflation be taken into account. In fact, the prudent fund manager would add another amount as a hedge against future inflation.

Although the laws governing educational endowments vary from state to state, the pattern has begun to emerge in recent years. Twenty years ago the practice of "pooling" endowment funds to permit more effective and efficient management was frowned upon. Today, partially as a result of the success of

7. P. 18.

the mutual stock funds, pooling has become a common and accepted practice. In general, it would appear that the legal position of the charitable corporation is marked by the absence of legislation and definitive cases rather than by a burden of proliferating statutes. There appears to be no authority, for example, that realized gains in endowment funds must be treated as principal. The standard by which the directors of a charitable corporation are most often judged in the administration of the corporations' affairs is that by which "a man of common prudence ordinarily exercises in his own affairs."[8] This so-called "prudent man rule" is becoming the major guideline in the control of endowment funds. The evolution of this approach has opened new vistas to the fund managers.

The authors have suggested that it would be useful to all concerned if the questions of the legality of classifying realized gains of endowment funds as income could be put to the courts for a declaratory judgment. Such a move could not help but be in the interest of higher education. Even if the courts delivered a negative opinion, the institutions would be in no worse a position than the one they now occupy. Without such a judgment, few lawyers will feel that they can advise educational institutions that they may, with complete safety, make use of realized gains. An alternative approach would be the enactment of new legislation covering the problem. While this would be advantageous in many respects, it would pose the problem of new legislation in all 50 states. A third, and more direct, approach would be for the institutions concerned to change the wording of the donative instruments for future endowments and thereby expressly provide for the needed flexibility. This last approach would not, of course, improve the situation with regard to existing endowment funds.

The authors' summary of these aspects of the legal relationships existing at the present time is succinct and definitive: "Donors, legislatures and the common law alike have as a rule given educational institutions wide discretion in the choice of investments. The requirement most frequently applied is that the institution invest as a prudent man would invest his own funds for the long term, having in mind both income and the safety of capital. Today, capital cannot be considered safe unless its purchasing power is protected."[9] Neither directors nor trustees are liable under the law for reasonable mistakes of judgment or imperfect predictions of future events. Proof of bad faith or willful neglect are usually required before liability will attach. Given these reassurances, most fund managers can relax.

The Report has made a substantive contribution in identifying and explaining the legal restrictions and opportunities within which the educational fund director must operate in carrying forward his assignment. They have made it clear that if there are difficulties in the task of implementing sound investment policies, they are not legal difficulties. The supposed legal difficulties are more

8. P. 40.
9. P. 58.

apparent than real. There is no legal support for the belief that realized gains from endowment funds cannot be spent, so long as the expenditures are made prudently. The law, as usual, has attempted to keep pace with change and progress.

The question which remains unanswered is what effect the federal legislation concerning the taxing of realized gains, currently being considered by the Senate, will have on the posture of fund managers. If the new legislation, already approved by the House, assessing seven and one-half percent tax on earned income is approved by the Senate, a new approach may be required. It may then be to the advantage of institutions to keep their gains in the "unrealized" column rather than the "realized" column, thereby reducing their net income figures, at least for the moment. It is hoped that the income tax provision will not be approved since it could result in reversing the more liberal and profitable trend that is finally underway in educational fund management.