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Understanding  
the Legal  
Responsibilities of  
Charitable Trustees  
and Directors

**BRIEFING »**

## The Prudent Fiduciary

Charitable trustees and directors play a critical role in serving America's social and cultural needs. However, they also have certain legal responsibilities, especially when the management of charitable funds is involved. Specific fiduciary rules govern their investment decisions.

**I**n thinking about these issues, trustees and directors should keep these points in mind:

- There are key distinctions between charitable trusts and charitable corporations. Trustees operate under common law rules, as interpreted by the courts. The fiduciary duties of charitable directors are set by state incorporation statutes.
- Trustees traditionally have fallen under a stricter legal standard than charitable directors. They are expected to show the same prudence as any competent investor would under similar circumstances. They may be held personally liable for fiduciary negligence.
- Charitable trustees and directors both are subject to the regulatory supervision of their state Attorney General, who can seek sanctions against them in cases involving fiduciary negligence or malfeasance.
- Nonprofit directors are granted wider discretion under a legal principle known as the “business judgement” rule. However, they also are expected to exercise prudent financial judgment.

## The Prudent Fiduciary

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- Efforts to modernize trust rules have spurred development of a model law, the Uniform Prudent Investor Act (UPIA). The law, which has been adopted in a majority of the states, gives trustees greater leeway to pursue effective investment strategies and clarifies their authority to hire outside portfolio managers to carry out those strategies.
- While directors of charitable corporations continue to be governed by different legal standards, the prudent investing standards outlined in the UPIA are extended to them in another model act—the Uniform Prudent Management of Institutional Funds Act (UPMIFA).
- Traditional fiduciary rules discouraged trustees from using the tools of modern investment theory to build diversified portfolios. Academic studies have shown that this resulted in lower returns and higher risks for many trusts.
- Modern trust law—as codified by the UPIA and the UPMIFA—allows trustees to pursue diversified investment strategies, even when they involve the risk of capital loss on some assets. The key consideration is whether the entire portfolio is prudent in light of the organization’s funding needs and tolerance for risk.
- Fiduciaries must show due diligence in selecting, evaluating and monitoring portfolio managers. If delegation decisions are made prudently, fiduciaries will not be held liable for the manager’s specific investment actions.
- Fiduciaries need to document their decisions. Among other things, these records should include a written investment policy, background reports on any managers hired and account statements showing risk-adjusted performance.
- The UPIA and the UPMIFA potentially increase the liability of charitable fiduciaries. If found negligent, they may be held personally accountable—not only for actual losses, but also for the returns that might have been achieved if prudent judgment had been used.
- The law recognizes that portfolio management is a complex, demanding task that may require full-time professional attention. In some cases, the use of investment professionals may be required under UPIA and UPMIFA, not just authorized by it.
- Despite the UPIA and the UPMIFA, charitable trustees still face obstacles to effective financial management. Many involve the legal distinction between trust “principal” and “income.”
- Trustees and directors of tax-exempt private foundations also are subject to IRS regulations designed to prevent investments that would “jeopardize” the foundation’s tax-exempt purpose.
- For more than 30 years, Consulting Group has been helping fiduciaries manage their legal responsibilities. Our Financial Advisors help clients develop investment strategies, select appropriate managers to execute those strategies and evaluate manager performance over time.

Each year, thousands of Americans generously give up their time to supervise a school, church, museum or other philanthropic institution. Without their dedication, many of the nation's social and cultural needs might go unmet.

But a seat on a charitable board also carries with it serious legal responsibilities—even when, as in the majority of cases, the position is unpaid. Trustees and directors operate under rules that define their fiduciary duties—and the penalties that can be imposed on them for failing to meet those obligations.

These rules can be especially demanding where the management of charitable funds is involved. Fiduciaries are required to use prudent judgment when making investment decisions. Inevitably, this means walking a line between excessive caution and excessive risk. Finding that line isn't always easy.

Many of the rules governing charitable fiduciaries are rooted in common law—a body of legal precedents created through centuries of court cases. But in recent years these principles have been revised to bring them in line with modern investment practice.

Greater flexibility, however, has also brought greater accountability. Charitable fiduciaries are expected to exercise due diligence in drafting investment policies, selecting portfolio managers and monitoring the performance of those managers over time. If found negligent, they may be held liable—not only for actual losses, but also for the returns that might have been achieved if prudent judgment had been used.

The purpose of this paper is to review the rules that apply to charitable fiduciaries and highlight some key considerations every director or trustee should keep in mind. For those interested in learning more about these issues, a bibliography is included on pages 17 – 18.

However, this paper is not intended as a substitute for qualified legal advice. While the information here has been gathered from sources we believe reliable, we cannot guarantee its accuracy or completeness. If you have questions about specific legal matters affecting you or your organization, please consult your attorney.

There's little question that serving on a charitable board can be a rewarding experience—and a valuable contribution to society.

## Legal Overview

To understand the fiduciary rules that apply to charitable investors, it helps to know something about the legal framework of the nonprofit sector.

While the fiduciary standards governing different types of organizations—such as charitable trusts and nonprofit corporations—have become somewhat blurred in recent years, some important distinctions remain. Broadly, trustees tend to be held to stricter standards of conduct and personal liability, while nonprofit directors generally are shielded by their status as corporate officers. There are exceptions to this pattern, however.

Most philanthropic organizations share at least one trait—they are exempt from federal income tax under section 501(c)3 of the Internal Revenue Code. The tax code further divides the 501(c)3 universe into two categories: “public” charities and “private” foundations. Public charities are those that meet certain tests designed to show broad support for their programs. Private foundations are deemed to reflect the priorities of a more limited number of donors. Officers and directors of private foundations are subject to certain investment rules enforced by the IRS.

Whatever their tax status, charitable entities usually take one of two basic legal forms: a trust or a nonprofit corporation. This distinction can be obscured by the fact that many nonprofit corporations refer to their board members as “trustees,” while some charitable trusts appear to be organized along corporate lines. But the difference is more than just a matter of labels. It can determine whether a board member—whatever his or her title—will be governed by fiduciary rules based on the common law of trusts or by the somewhat different standards applied to corporate boards.

### WHAT IS A TRUST?

Technically, a trust is defined as a legal relationship between persons having a beneficial interest in a property and other persons who have been given legal title to that property. The legal owners are called trustees, while the equitable owners are the beneficiaries. The person creating the trust is known as the settlor or donor.

Trusts are created by means of a trust instrument—a document prepared by the settlor that names the trustees and the beneficiaries, identifies the assets to be placed in the trust and specifies how the trust income is to be divided. It may include specific instructions about how the assets in the trust should be managed. In the case of private trusts, the instrument may also designate a terminal beneficiary, or remainderman, to receive the remaining assets when the trust is dissolved.

Trustees are obligated to manage the trust in accordance with the terms of the trust instrument and solely in the financial interest of the beneficiaries. If they fail to carry out these tasks properly, the beneficiaries may ask the courts for relief, including monetary damages for losses due to negligence. Trustees are jointly and severally liable, meaning one trustee may be held fully liable for the negligence of other trustees.

In seeking to define the legal obligations of trustees, courts have identified four general duties:

- **Duty of Care:** Trustees are expected to show the same degree of skill and attention as any prudent investor would in a similar situation. This is the

“prudent investor” or “prudent man” rule. Investment decisions are judged not by the actual results, but rather by the soundness of the decision-making process that led to those results.

- **Duty to Make the Trust Productive:** Trustees are expected to obtain returns commensurate with the terms of the trust, the needs of the beneficiaries and prevailing economic and financial conditions.
- **Duty of Loyalty:** Trustees are expected to avoid transactions that might pose a conflict of interest. Financial dealings between the trustee and the trust—such as the purchase or sale of property—are forbidden under most circumstances.
- **Duty of Impartiality:** Unless authorized by the trust instrument, trustees cannot favor one beneficiary over another. This issue can arise in cases where trust income is earmarked for one beneficiary, but trust principal is reserved for another.

### CHARITABLE TRUSTS

Most trusts are created for a private purpose, such as providing for the support of a spouse or other family member. Charitable trusts, on the other hand, serve a broad class of beneficiaries, such as the poor or patrons of the arts. Some trusts have both private and charitable beneficiaries and may be covered by some of the fiduciary standards that apply to charities, such as the IRS rules governing private foundations.

As mentioned above, trust beneficiaries can take a trustee to court if they believe trust assets have been mismanaged. Charitable trusts, on the other hand, don't have individual beneficiaries. Instead, trust enforcement power typically rests with the attorney general in the state where the trust is domiciled. Most state attorneys general have offices to regulate charitable organizations. If wrongdoing or imprudent conduct is suspected, this office can ask the courts to intervene. Such suits are relatively rare, but they do happen.

### WHAT IS A NONPROFIT CORPORATION?

The majority of all 501(c)3 charities are incorporated entities, meaning they have a legal status separate and distinct from their officers and directors. Nonprofit corporations typically are created by means of a state charter.

Although most states have separate laws governing for-profit and nonprofit corporations, many of the legal precedents applied to charitable directors are derived from the world of business. For example, courts have long recognized that directors of for-profit companies may need to take risks—sometimes big ones—to fend off competitors or exploit new markets. As a result, judges are reluctant to second-guess decisions made by corporate boards. This has led to the development of the “business judgment” rule which shields corporate directors from liability for losses except in cases of “gross” negligence. In many states, though not all, this standard applies to nonprofit directors as well.<sup>1</sup>

Within the bounds of the business judgment rule, however, charitable directors are still expected to show reasonable care when making investment decisions. The definition of this duty is similar to the “prudent investor” rule applied to trustees. The Revised Model Nonprofit Corporation Act, drafted by the American Bar Association, describes it as an obligation to act “with the care an ordinarily prudent person in a like position would exercise under similar circumstances.”<sup>2</sup>

Business corporations have stockholders who can sue the directors if they think the company has been mismanaged. Charitable corporations, on the other hand, don't have stockholders. With few exceptions, fiduciary misconduct suits against charitable directors are brought by state attorneys general.<sup>3</sup>

<sup>1</sup> Daniel L. Kurtz, *Board Liability, Guide for Nonprofit Directors* (Mt. Kisco: Moyer Bell Ltd., 1988), pp. 49 – 51; and Evelyn Brody, “The Limits of Charity Fiduciary Law,” *University of Maryland Law Review* 57 (1998), p. 1426.

<sup>2</sup> *Revised Model Nonprofit Corporation Act*, American Bar Association, sec. 8.30 (1987).

<sup>3</sup> Daniel L. Kurtz, *Board Liability*, pp. 92 – 93.

## Trustee Liability

### » A CASE STUDY

The newspaper publisher was a generous man and an early supporter of the civil rights movement. So when he died in 1945, he set up a \$600,000 trust fund to pay for health care services for low-income African-Americans in his community.

The publisher appointed a local bank as trustee, with instructions to use part of the money to pay monthly stipends to 11 of his heirs and the rest of the funds to finance his health care bequest. But 41

years later, not a penny had been spent on health services. What's more, during that time the fund had grown to just \$2 million—an average return of less than 3% per year.

Several of the publisher's heirs sued the trustee, which had invested the trust in safe but low-yielding bonds. The heirs argued the trustee could have earned a higher return by switching to a more diversified portfolio in 1972, when state law was changed to allow such investments. The state's attorney general

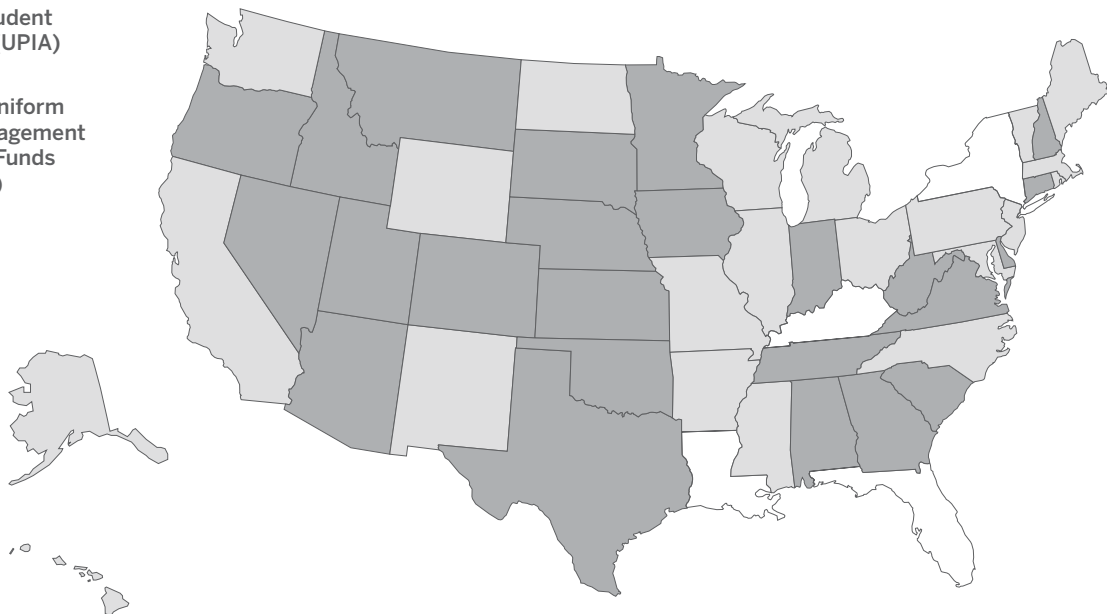
intervened in the case on behalf of the trust's charitable beneficiaries.

After several years of litigation, the case was settled out of court. The trustee agreed to pay \$150,000 to reimburse the trust and contributed another \$500,000 to health programs serving low-income African-Americans.<sup>4</sup>

<sup>4</sup>"NationsBank, Georgia Reach a Settlement on Publisher's Estate," *The Wall Street Journal*, 9 February 1988, p. B5; and "NationsBank Announces Commitment to Contribute \$500,000 for the Health Needs of Indigent African Americans in Macon, Georgia Area," *PR Newswire*, 16 October 1996.

### STATE LAWS GOVERNING THE FIDUCIARY DUTIES OF CHARITABLE DIRECTORS AND TRUSTEES As of July 2008

- Uniform Prudent Investor Act (UPIA)
- UPIA and Uniform Prudent Management Institutional Funds Act (UPMIFA)



Source: National Conference of Commissioners on Uniform State Laws.

**MODEL ACTS**

In addition to the broad standards applied to trustees and directors, most states also have laws that specifically regulate the investment of charitable funds. Many are based on model statutes drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL), an advisory panel of judges and other experts. The two most important of these model acts are:

- The Uniform Prudent Investor Act (UPIA). First put forward in 1994, the UPIA erases many of the investment constraints once imposed on trustees. For example, the model act clarifies the right of trustees to delegate their investment powers to outside money managers, and removes limits that in some jurisdictions required trustees to limit their portfolios to a list of state-approved asset classes. At the same time, however, the UPIA set a new standard for judging trustee investment decisions, by requiring them to diversify their holdings and adequately balance potential risk against potential return at the portfolio level. So far, the UPIA has been adopted in 44 states and the District of Columbia. Several states, such as New York, have laws similar to, but not based upon, the UPIA.
- The Uniform Prudent Management of Institutional Funds Act (UPMIFA). In July 2006, the NCCUSL approved a model act that extends the prudent investor requirements of the UPIA to directors of charitable corporations. The proposed new law updates the Uniform Management of Institutional Funds Act (UMIFA) first recommended in 1972 and adopted by 47 states and the

District of Columbia. The 1972 model law clarified that charitable directors were not bound by the same investment restrictions then applied to trustees. However, as noted above, most of those limits have since been lifted. Accordingly, the new model act (UPMIFA) makes it clear that charitable directors are expected to abide by the same prudent investment standards outlined in the UPIA. As of 2008, UPMIFA has been adopted by 23 states, the District of Columbia and introduced for consideration in other states.

As if separate standards for charitable trustees and charitable directors were not confusing enough, courts and state legislatures also have shown a certain inconsistency in how they apply those rules. Some courts have used the strict standards that govern trustee conduct to judge nonprofit directors as well. Others have shown a willingness to use a more relaxed interpretation of trust law in cases involving nonprofit directors. Still others have extended that same flexibility to cases involving charitable, as opposed to private, trustees.

State law can be even more confusing. Some states, such as Pennsylvania, exclude investment decisions by charitable directors from the fiduciary standards otherwise applied to nonprofit corporations. Other states carve out exemptions for directors of specific types of charities (such as college endowments and private foundations) and hold them to the stricter trustee standard.<sup>5</sup> Board members who wish to understand the particular rules that apply in their own states should consult an attorney who specializes in nonprofit law.

**TOWARD A MODERN STANDARD**

Legal scholars have long recognized the need for a more coherent, more consistent fiduciary standard for all charitable board members. To a large extent, the UPIA and the UPMIFA are designed to further that goal. While these acts are specifically aimed at modernizing trust law, they also reflect the view that charitable directors, because of the nature of their duties, should be held to a higher standard than directors of business corporations.<sup>6</sup> The drafters of the UPIA put it this way: “Although the [UPIA] by its terms applies to trusts and not to charitable corporations, the standards of the act can be expected to inform the investment responsibilities of directors... of charitable corporations.”<sup>7</sup> UPMIFA explicitly makes that prediction a reality.

<sup>5</sup> Lewis D. Salomon and Karen C. Coe, “The Legal Aspects of Social Investing by Non-Profit Fiduciaries,” *University of Missouri at Kansas City Law Review* 66 (Winter 1997), p. 217.

<sup>6</sup> “The duties of the members of the governing board of a charitable corporation are generally similar to the duties of the trustee of a charitable trust.” American Law Institute, *Restatement of the Law, Trusts (Third)*, (St. Paul: American Law Institute Publishers, 1992), p. 190.

<sup>7</sup> *Uniform Prudent Investor Act*, Prefatory Note, National Conference of Commissioners on Uniform State Laws (1994).

## Modern Portfolio Theory

### MODERN PORTFOLIO THEORY IN A NUTSHELL

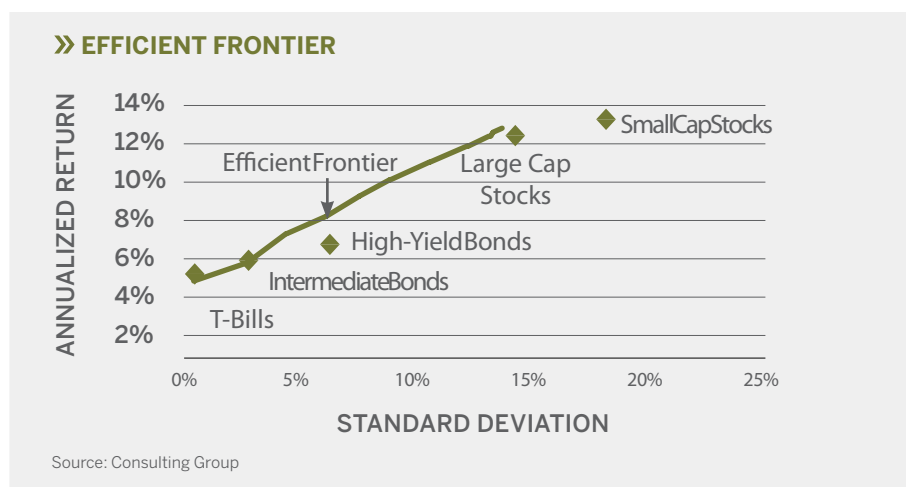
Much of what makes UPIA and UPMIFA such landmarks stems from their effort to reconcile traditional trust rules with decades of research into the relationship between investment risk and return. Collectively, this body of knowledge is known as Modern Portfolio Theory, or MPT. These findings have shaped many of the tools used by the professional investment community today.

By giving MPT the backing of law, UPIA and UPMIFA create a more flexible set of rules for charitable trustees. In a sense, they mark a return to the original prudent investor standard, which was set down in an 1830 court decision. That ruling was designed to give trustees greater investment discretion than allowed by existing precedents inherited from England.

One of the basic tenets of Modern Portfolio theory (MPT) is that returns on various assets are directly related to the risks involved in holding them. Risk typically is measured in terms of the volatility of returns, using a statistical tool known as standard deviation. The greater the risk, the greater the return investors should expect for taking that risk.

This relationship is displayed on the chart. Returns are shown on the vertical scale; standard deviation on the horizontal. Notice that different asset classes fall at different points on the chart. U.S. Treasury bills, for example, have low volatility but pay relatively low returns. Stocks are more volatile, but historically have paid higher returns.

Based on the expected behavior of various asset classes, it may be possible to combine them into diversified portfolios



designed to maximize returns for any given level of risk or reduce risk for any given level of returns. In theory, these portfolios will fall along the line shown on the chart. This line is known as the efficient frontier.

A similar analysis can be applied to specific securities, such as the stocks in the Standard & Poor's 500 Index. The risk of holding a stock is measured by its beta—the degree to which its returns are more or less volatile than the index as a whole. Stocks that are riskier than the market are said to have high betas. Stocks with below-average risk are said to have low betas.

MPT holds that financial markets are relatively efficient, meaning that over time the returns on specific assets will tend to reflect their relative volatility. But some of this risk may be neutralized through diversification—the creation of optimized portfolios. The amount of risk that can be offset depends on how asset returns are correlated. If returns tend to move in the same direction at the same time, they are positively correlated. If they move

in different directions, they are uncorrelated. The lower the correlation, the more risk can be offset through portfolio diversification.

Because of this, MPT divides investment risk into two pieces. The first piece stems from the unique volatility of the asset itself. This is known as diversifiable risk, because it can be offset through diversification. The second part is due to the volatility of the market as a whole. This is called portfolio risk, or non-diversifiable risk, because it can't be eliminated by portfolio diversification.

From these insights into the connection between risk and return flow certain conclusions about the nature of prudent investing. They highlight the fact that decisions about which assets to hold in a portfolio are all related and should not be made, or evaluated, in isolation.

Even relatively risky securities, such as high-yield bonds or emerging market equities, can be prudent investments, if they improve the risk-adjusted performance of the total portfolio. Even

relatively safe investments, such as Treasury bonds, may be imprudent if they detract from overall portfolio performance. The proper portfolio mix depends on the investor's tolerance for risk and projected time horizon.

Because most charitable trusts and endowments are perpetual—and thus have no fixed investment horizon—charitable fiduciaries might be justified in adopting relatively aggressive investment policies, accepting risks that other fiduciaries would prudently avoid.

### DISORDER IN THE COURTS

Over the years, however, the original intent of the “Prudent Man Rule” was lost as courts and state lawmakers interpreted and reinterpreted the standard.

Some states, for example, adopted “legal lists” of authorized trust investments. Typically, these were limited to government securities or other supposedly safe assets. Nonlisted assets were presumed imprudent and banned unless the trust instrument specifically gave the trustee discretion to invest in them.<sup>8</sup>

In a number of states, courts also took the approach that prudence should be judged on an asset-by-asset basis, ignoring overall portfolio performance. This meant trustees could be—and often were—held liable for losses on specific securities, even when the portfolio as a whole delivered stable, adequate returns.

While this rule may have allowed some trustees to escape liability for bad decisions simply because they happened to invest in a bull market, it also tended to discourage diversification, which assumes that losses on some assets can and will be offset by gains on others.

The prevailing legal doctrine also frowned on the use of outside investment advisors or portfolio managers, which was held to be an improper delegation of a trustee's fiduciary responsibilities. While this didn't stop many trustees from seeking expert advice—in effect, delegating under the table—it did leave them in a very difficult legal position if investments recommended by an advisor were later held to be imprudent.<sup>9</sup>

These interpretations made it hard, if not impossible, for many charitable trustees to manage their endowments effectively.

Academic research has documented that the old rules had a significant distorting effect on the performance of many trust funds over the years, reducing returns and increasing portfolio risk.<sup>10</sup>

<sup>8</sup>W. Brantley Phillips, Jr., “Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts,” *Washington & Lee Law Review* 54 (Winter 1997), p. 341.

<sup>9</sup>John H. Langbein, “Reversing the Nondelegation Rule of Trust Investment Law,” *Missouri Law Review* 59 (Winter 1994), p. 110.

<sup>10</sup>Diane Del Guercio, “The Distorting Effect of the Prudent Man Laws on Institutional Equity Investments,” *Journal of Financial Economics* 40 (January 1996), p. 60.

### » THE ORIGINS OF THE PRUDENT INVESTOR

When John McLean died in 1823, he placed \$50,000 in trust, with instructions that the income should be paid to his wife for life, with the principal then going to two charitable organizations: Harvard College and Massachusetts General Hospital.

The trustees invested the funds in a selection of bank, insurance and manufacturing stocks. At the time, many legal authorities considered equities to be inherently imprudent—a doctrine originally based on British law.

The two charities petitioned for relief, arguing that capital losses on the stocks had seriously reduced trust principal. They asked the court to force the trustees to make good the losses out of income and reinvest the funds in less risky assets, such as government bonds. The case ended up before the Massachusetts Supreme Court.

The court's ruling set a new, more flexible standard for fiduciary conduct. Dismissing the argument that trustees should never risk the loss of principal, Judge Samuel Putnam noted that all assets, even government bonds, carry some element of risk.

“Do what you will, the capital is at hazard,” he wrote. Putnam went on to set down one of the most famous doctrines in American jurisprudence:

“All that can be required of a trustee . . . is that he 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 the probable income as well as the probable safety of the capital to be invested.”

This “prudent man” test became the basis for the modern “prudent investor” rule.

## The Prudent Investor Rule

The new interpretation of the prudent investor rule redefines ways that should allow trustees and directors to do a more efficient job of managing their investment responsibilities.

With the passage of time, more and more legal experts became dissatisfied with what they saw as an obsolete fiduciary standard.

Passage of the Federal Employee Retirement Income Security Act, or ERISA, in 1974, only heightened the debate. ERISA modernized many of the rules applied to pension trustees but left other fiduciaries operating under the old doctrines.

In response to these concerns, the American Law Institute, a nonprofit group that seeks to clarify principles of common law, began work on its Third Restatement of the Law of Trusts—an authoritative commentary on all aspects of the legal responsibilities of trustees. The first installment of that work, dealing with the prudent investor rule, was issued in 1992. It was the intellectual foundation for the UPIA and is likely to influence future court rulings involving charitable fiduciaries.

### RESTATING THE LAW

The new interpretation didn't abolish the prudent investor rule, but it did redefine it in ways that should allow trustees and directors to do a more efficient job of managing their investment responsibilities. Some of these changes:

- Investments should be judged based on the total portfolio. Losses on a particular asset, no matter how large, are not grounds for liability as long as the decision to purchase that asset was part of a sound overall portfolio strategy. "An investment that might be imprudent standing alone can become prudent if undertaken in sensible relation to other trust assets."<sup>11</sup>

- No investments are flatly forbidden. Charitable fiduciaries may invest in any asset that reasonably can be expected to improve portfolio performance. This may include foreign stocks and bonds, mortgage-backed securities, venture capital investments—even hedging instruments, futures and other derivative instruments. "The prudent investor rule... does not classify specific investments or courses of action as prudent or imprudent in the abstract."<sup>12</sup>
- Risk is to be managed, not avoided. The new interpretation accepts that risk is inevitable in any investment program and must be managed at the portfolio level. It requires only that the portfolio risks taken be commensurate with the return objective, which in turn should reflect the purposes of the endowment. "The degree of risk permitted... is ultimately a matter for interpretation and judgment."<sup>13</sup>
- Delegation is clearly authorized. Charitable fiduciaries may rely upon independent investment managers—as long as they exercise due diligence in selecting, evaluating and monitoring those managers. If delegation is done appropriately, a fiduciary will not be held liable for a manager's investment decisions.<sup>14</sup>

<sup>11</sup> *Uniform Prudent Investor Act*, sec. 2, comments, NCCUSL.

<sup>12</sup> *Restatement of the Law*, Trusts (Third), p. 21.

<sup>13</sup> *Ibid.*, p. 21.

<sup>14</sup> *Uniform Prudent Investor Act*, secs. 9(a) and 9(c), NCCUSL.

It is important for charitable trustees and directors to understand that while the new standard gives them the tools they need to manage their duties more effectively, it also expects them to use these tools wisely. In other words, the bar—the legally acceptable level of financial skill and care—has been raised.

For example, fiduciaries now are expected to diversify their portfolios in an effort to achieve an optimal trade-off between risk and return. Typically, this involves developing an asset allocation plan that takes into account the returns and volatilities of different asset classes, as well as the correlations among them. Portfolio optimization is a complex process and can't be done on the back of an envelope. As one legal expert has noted, "it is important that a trustee be reasonably knowledgeable or have professional advice in order to achieve sound, informed diversification..."<sup>15</sup>

Because the investment process can be so complicated—and the results so uncertain—it is also crucial for trustees and directors to use procedural prudence in documenting their decisions. These records should include a written investment policy, notes of investment discussions by the board or any of its committees, a detailed description of the process used to select outside money managers, background reports on those managers and account statements showing the risk-adjusted performance of the portfolio over time. As one expert puts it, "A paper trail, showing a full trust management system, is a lifesaver if a trustee is called upon to defend an investment loss."<sup>16</sup>

### TRUSTEE LIABILITY

The potential penalties for getting it wrong have also increased. Traditionally, judges have been reluctant to assess damages against trustees for returns that could have been earned through prudent investment. At worst, a trustee might be held liable for decisions about specific assets. If a trustee sold a particular stock, for example, and the sale later was held to be imprudent, he or she might be charged for any price appreciation after the sale, plus dividends. If a trustee imprudently bought a stock and it declined in value, he or she might be required to reimburse the trust for that loss—but not for gains that would have occurred if those funds had been prudently invested elsewhere.

The new rule, however, embraces a "total return" approach. If a trustee fails to obtain the returns—adjusted for risk—that reasonably could have been expected under prevailing market conditions, he or she could be held liable for the difference. To determine liability, the trust's performance might be compared to returns on similar institutional portfolios, or to market benchmarks, such as the Standard & Poor's 500 Stock Index. Of course, such a standard can cut both ways. As one expert has noted: "Not only will trustees no longer be insulated from liability during rising markets, but the total return approach will also protect trustees from excessively harsh treatment in periods of general market decline."<sup>17</sup>

### THE INFLATION THREAT

Finally, trustees need to be mindful of the corrosive effect that inflation may have on the value of an endowment over time. Traditional interpretations of the prudent investor rule primarily were concerned with protecting the nominal value of trust assets. This encouraged trustees to invest heavily in U.S. Treasury bonds or other securities that posed little risk of default, but which were extremely vulnerable to inflation. The new rule makes it clear that erosion of purchasing power is equivalent to a loss of trust principal and must be guarded against.

Inflation can be a particularly significant consideration in cases where one trust beneficiary—such as an individual—has the right to trust income, while another beneficiary—such as a charity—is entitled to principal. If trustees favor an investment policy that produces high income but allows the principal to be badly eroded by inflation, they could violate their legal duty to treat all beneficiaries impartially.

<sup>15</sup> Edward C. Halbach, Jr., "Trust Investment Law in the Third Restatement," *Iowa Law Review* 77 (March 1992), p. 1162.

<sup>16</sup> John Train and Thomas A. Melfe, *Investing and Managing Trusts Under the New Prudent Investor Rule* (Boston: Harvard Business School Press, 1999), p. 37.

<sup>17</sup> Halbach, "Trust Investment Law in the Third Restatement," p. 1182.

## A Duty to Diversify

Trustees not only are expected to diversify, they are expected to use diversification in an effort to achieve the best possible trade-off between portfolio risk and return.

Courts in many states have long held that trustees have an obligation to diversify investments to avoid catastrophic loss—unless the terms of the trust say otherwise. This might be the case, for example, where a trust has been created to hold a family farm or business.

Such exceptions rarely apply to charitable trusts. Nor can trustees rely on the safety or soundness of the individual assets in their portfolios to protect them from liability. An Ohio court, for example, ruled against one trustee for investing the bulk of a trust fund in just two stocks—even though both companies, Dow Chemical and Union Carbide, were well-established, blue-chip corporations at the time.

The prudent investor rule imposes an even tougher test: Trustees not only are expected to diversify, they are expected to use diversification in an effort to achieve the best possible trade-off between portfolio risk and return.

Modern portfolio theory holds that investors are not compensated for taking risks that can be avoided through diversification. Taking risks without being paid for them is imprudent. Therefore, the new rule reasons, a prudent investor should develop an asset allocation plan that holds diversifiable risk to a minimum.<sup>18</sup>

<sup>18</sup> *Stevens v. National City Bank*, 45 Ohio St. 3d. 276, 544 N.E. 2nd 612 (1989).

### A DUTY TO DELEGATE

Charitable trustees are not required to be financial experts. Given the complexity of today's financial markets, though, they may need expert advice. That's why the prudent investor rule permits them to delegate investment decisions to professional money managers.

Some experts suggest such delegation is not only authorized, it may be required under some circumstances. If a trustee doesn't have the skill, or the time, to manage an investment portfolio properly, he or she might be obligated to turn the job over to someone who does.

The Third Restatement of the Law of Trusts, an influential legal source, puts it this way: "A trustee's discretionary authority... may be abused by imprudent failure to delegate as well as by making an imprudent decision to delegate."

Of course, this doesn't relieve trustees of the need to use care in making delegation decisions. But it does recognize, in the words of Yale University law professor John Langbein, that "managing a portfolio is as demanding a specialty as stomach surgery or nuclear engineering. There is no more reason to expect the ordinary individual serving as trustee to possess the requisite investment experience than to expect ordinary citizens to possess expertise in gastro-enterology or atomic science."

### THORNY ISSUES

While the Uniform Prudent Investor Act has swept away many of the time-worn ideas that previously hindered proper investment of charitable endowments, several thorny issues remain. One of the most complex involves the legal treatment of trust income and principal.

Many trust and endowment instruments prohibit trustees from invading principal, requiring charitable fiduciaries to limit spending to dividends, interest or other “income” items. Modern portfolio theory, however, teaches that investors should seek to maximize total return—which may include capital gains. Indeed, in recent years many top-performing companies have shunned dividends, instead using stock buybacks and other rewards based on capital growth to compensate investors.

Unfortunately, the distinction between principal and income is rigidly defined in trust law, giving fiduciaries little flexibility to spend capital gains.

A total return approach might raise the value of an endowment but leave the organization unable to spend it. By the same token, a policy that maximized “income” might produce inferior total returns.

In many states, this problem already has been solved for charitable directors. UMIFA, the Uniform Management of Institutional Funds Act, allows them to spend amounts in excess of a restricted endowment’s “historical value,” defined as the dollar amount of the original gift. This allows them to spend capital gains—even if the gift’s terms restrict spending to “income,” or call on the board to “preserve principal.”<sup>19</sup> The Uniform Prudent Management of Institutional Funds Act (UPMIFA) eliminates the historical value test altogether, instead requiring charitable fiduciaries to exercise prudent judgment in setting spending policies. Like UMIFA, the new model law allows fiduciaries to base their decisions on a fund’s total returns—avoiding artificial distinctions between “principal” and “income.”<sup>20</sup>

Of course, this doesn’t help charitable trustees—or charitable directors in states where they are treated like trustees. Another model law, the Uniform Principal and Income Act, does give trustees the flexibility to “adjust” income to include capital gains under certain circumstances.<sup>21</sup> This power may be limited, however, in cases involving charitable trusts. Trustees should consult their attorneys to find out what rules apply to their situation.

### “JEOPARDY” INVESTMENTS

In addition to the state and common law principles governing charitable fiduciaries, directors of private foundations are covered by a set of federal standards enforced by the IRS. These rules generally regulate financial transactions between foundations and their officers and major donors, but they also impose penalties on directors found liable for what the law terms “jeopardy” investments.

<sup>19</sup> *Uniform Management of Institutional Funds Act*, secs. 1 and 2 and comments, NCCUSL (1972).

<sup>20</sup> *Uniform Prudent Management of Institutional Funds Act*, Final Draft, NCCUSL (2006).

<sup>21</sup> *Uniform Principal and Income Act*, secs. 104 and comments, NCCUSL (1997).

## Sarbanes-Oxley

The law is not clear about what constitutes a jeopardy investment, except to define it as any investment that “jeopardizes” the foundation’s tax-exempt purpose. IRS regulations have interpreted this to mean any investment that would threaten the foundation’s short-term or long-term financial health. But, the rules add, decisions about specific investments should be judged based on their effect on the foundation’s entire portfolio.

Under the law, foundation directors may be held liable for jeopardy investments if they fail to exercise “ordinary business care and prudence”—a standard similar to the “business judgment” rule of common law. Directors who knowingly approve an improper investment may be charged a special penalty tax equal to 5% of the invested amount, up to a maximum of \$5,000. If the prohibited investment is not liquidated after a certain period of time, typically one year, an additional penalty, equal to 5% or \$10,000, also may be levied. These penalties may be waived, however, in cases where directors made the investment upon the advice of a qualified investment advisor.<sup>22</sup>

Because there has been relatively little litigation on the subject, the rules governing jeopardy investments remain uncertain. Some experts, however, have interpreted IRS regulations as requiring foundations to diversify in a prudent manner.<sup>23</sup> Other IRS rulings suggest that foundations wishing to invest in more aggressive instruments, such as commodities and hedge funds, need to obtain competent professional investment advice.<sup>24</sup>

### SARBANES-OXLEY

In response to a string of business scandals, Congress passed the American Competitiveness and Corporate Accountability Act in July of 2002. Commonly known as the Sarbanes-Oxley law, the act imposed tighter accounting and reporting standards on publicly held corporations.

For example, Sarbanes-Oxley requires that a company’s top executives certify the accuracy and completeness of the firm’s financial statements. It also limits the ability of accounting firms to sell other services—such as management consulting—to the companies they audit.

For the most part, Sarbanes-Oxley only regulates the conduct of for-profit, public companies. However, two specific provisions also apply to nonprofit corporations:

- Whistleblower protection. The law prohibits retaliation against employees, auditors or other insiders who report acts of financial misconduct, either to corporate officers or to outside regulators and law enforcement agencies.
- Document preservation. The law makes it a federal crime to alter, conceal or destroy corporate records in order to prevent their use in an official investigation or legal proceeding.

While not directly related to the portfolio management process, these provisions highlight the importance of having clear investment procedures and carefully documenting all financial decisions.

<sup>22</sup> Bruce R. Hopkins, *The Law of Tax-Exempt Organizations* (New York: John Wiley & Sons, 1987), pp. 53 – 58.

<sup>23</sup> Brody, “The Limits of Charity Fiduciary Law,” p. 1488.

<sup>24</sup> Internal Revenue Service, Letter Ruling 9451067, September 28, 1994.

Several states also have used Sarbanes-Oxley as a template for tighter nonprofit regulation. In 2004, for example, California adopted a requirement that nonprofit corporations with revenues of at least \$2 million have annual audited statements prepared by “independent” accounting firms—as defined in Sarbanes-Oxley.

For this reason, and because of the possibility some federal provisions may eventually be extended to nonprofits, many experts have advised charitable officials to familiarize themselves with the Sarbanes-Oxley law and voluntarily adopt the relevant standards and controls.<sup>25</sup>

<sup>25</sup> See Board Source and Independent Sector, “The Sarbanes-Oxley Act and Implications for Nonprofit Organizations,” 2003. <http://www.independentsector.org/PDFs/sarbanesoxley.pdf>.

Two specific provisions of Sarbanes-Oxley apply to nonprofit corporations: whistleblower protection and document preservation. Several states also have used Sarbanes-Oxley as a template for tighter nonprofit regulation.

## Conclusions

Prudent fiduciaries are expected to exercise due diligence in drafting investment policies, selecting portfolio managers and monitoring the performance of those managers over time.

The role of a trustee or director can be enormously rewarding. However, the responsibilities involved in charitable investing are substantial, and—as many readers probably have already concluded—can be complex.

It is generally believed that legal authorities are inclined to give charitable fiduciaries the benefit of the doubt. Monetary damages and other penalties are rarely imposed, except in cases of serious misconduct. Concerned individuals who wish to serve on the board of a worthy organization certainly shouldn't let legal concerns deter them.

There is also little question most charitable trustees and directors try to carry out their responsibilities properly—not out of fear of liability, but because they truly want to do what is best for their organization. Knowing what is best, however, requires a clear understanding of sound investment practice. In thinking about these issues, charitable fiduciaries should keep these following points in mind:

- The definition of prudence is changing and trustees and directors need

to change with it. They are expected to understand the trade-off between potential risk and return and design their strategies accordingly.

- Diversification is required in most cases. Fiduciaries need to develop asset allocation policies to ensure the portfolio returns they seek are commensurate with the risks they take.
- Having a defined investment process is one of the best defenses against accusations of imprudence. Charitable fiduciaries should make sure they can thoroughly document their decisions.
- The use of outside portfolio managers and advisors is permitted, and may be required in some circumstances. Fiduciaries need to show due diligence in screening and evaluating managers.
- For more than 30 years, Consulting Group has been helping fiduciaries manage their investment responsibilities. A Smith Barney Financial Advisor would be happy to provide you with information on the full range of services available.

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#### WEB SITES

##### **Association of Small Foundations:**

[www.smallfoundations.org](http://www.smallfoundations.org)  
Provides guidance and education to foundations with little or no staff.

##### **Chronicle of Philanthropy:**

[www.philanthropy.com](http://www.philanthropy.com)  
Leading newspaper covering the nonprofit sector.

##### **Council on Foundations:**

[www.cof.org](http://www.cof.org)  
For information on legislation and IRS actions affecting private foundations.

##### **International Center for Not-For-Profit Law:**

[www.icnl.org](http://www.icnl.org)  
Publishes online journal on legal issues affecting charitable organizations.

##### **Maryland Secretary of State:**

[www.sos.state.md.us/sos/charity/html/otstates.html](http://www.sos.state.md.us/sos/charity/html/otstates.html)  
Offers contact information for charity regulators in all 50 states.

##### **National Conference of Commissioners on Uniform State Laws:**

[www.nccusl.org](http://www.nccusl.org)  
Information on uniform acts, including state adoptions, legislative introductions, etc.

##### **Nonprofit Resource Center:**

[www.not-for-profit.org](http://www.not-for-profit.org)  
Offers information on a variety of legal topics, including fiduciary standards and regulation of charitable solicitation, as well as links to related sites.



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