

Reinhart Investor Lawyers

January 14, 2015

[James M. Bedore](#)
[Bryant E. Ferguson](#)
[Kyle B. Flanagan](#)
[Jeffrey R. Fuller](#)
[Steven D. Huff](#)
[Megan K. Jackson](#)
[Keith L. Johnson](#)
[Lucas J. Pagels](#)
[Jussi P. Snellman](#)
[Ryan S. Stippich](#)
[Gregory A. Storm](#)
[Benjamin D. Suesskind](#)
[John K. Tokarz](#)
[Nathan J. Wautier](#)

Suite 1700
 1000 North Water Street
 Milwaukee, WI 53202
 414-298-1000
 800-553-6215

Suite 600
 22 East Mifflin Street
 Madison, WI 53703
 608-229-2200
 800-728-6239

Suite One
 N16W23250 Stone Ridge Drive
 Waukesha, WI 53188
 262-951-4500
 800-928-5529

2215 Perrygreen Way
 Rockford, IL 61107
 815-633-5300
 800-840-5420

Suite 9400
 233 South Wacker Drive
 Chicago, IL 60606
 312-207-5456

Suite 205
 16220 North Scottsdale Road
 Scottsdale, AZ 85254
 480-860-0414

Penthouse
 8400 East Prentice Avenue
 Greenwood Village, CO 80111
 303-843-6042

www.reinhartlaw.com

EVOLVING FIDUCIARY DUTY OF FOUNDATIONS AND ENDOWMENTS

Directors, trustees and managers of foundations and endowments owe fiduciary duties to the organizations they oversee, similar to the fiduciary duties of directors at for-profit companies or pension trusts. However, foundations and endowments are different in important ways, including their charitable mission and tax exempt status. Unlike fiduciaries of for-profit companies or pension trusts, fiduciaries of foundations and endowments owe legal duties of obedience to both the organization's charitable mission and the social benefit purposes required of nonprofits. Accordingly, fiduciaries of foundations and endowments must approach investment decisions with these duties in mind.

"We believe that the fiduciary responsibilities of all philanthropic institutions mean that we have both a duty of obedience to our specific mission, and a duty of obedience to a larger public purpose. As a practical matter, we are obligated to examine our portfolio on an ongoing basis to identify holdings that may unintentionally do harm to our missions or to the broader shared interests of society."

Heron Foundation Investment Policy

Sources of Fiduciary Duty.

Foundations and endowments are typically structured as nonprofit corporations or trusts. The investment functions of most foundations and endowments are governed by state statutes based on model laws called the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which applies generally to all entities, and the Uniform Prudent Investor Act (UPIA), which applies specifically to trusts.¹ The Acts impose fiduciary obligations on directors, trustees and managers which include:

Fiduciary Duty ²	Fiduciaries shall:
Duty of Care/Prudence	Act in good faith, exercising the same care that an ordinarily prudent person in a like position would exercise under similar circumstances. Diversify investments, unless the purposes of the fund are better served without diversification. Take into consideration both general economic conditions and any asset's special relationship to the institution's charitable purposes.
Duty to Investigate	Make a reasonable effort to verify facts relevant to fund management and investment. This is often included as part of the duty of care.
Duty of Loyalty	Avoid self-dealing, misuse of funds and other misconduct.
Duty of Obedience	Perform duties with loyalty to the entity's mission and obedience to non-profit purposes. ³ This is often included as part of the duty of loyalty.
Duty to Minimize Costs	Incur only reasonable costs.

¹ See <http://www.uniformlaws.org/Act.aspx?title=Prudent%20Investor%20Act> and <http://uniformlaws.org/ActSummary.aspx?title=Prudent%20Management%20of%20Institutional%20Funds%20Act>.

² There are variations in how these duties are described across jurisdictions. The table is intended to provide a general overview.

Foundations and Endowments have a Non-Profit Purpose and Charitable Mission.

The fiduciary duties of foundations and endowments are most similar to the fiduciary duties of pension and other trust funds. However, fiduciaries of foundations and endowments have an additional duty of obedience to the unique charitable mission of the organization. The UPMIFA Drafting Committee advised in its Prefatory Note to the Act that "UPMIFA requires a charity and those who manage and invest its funds to... *develop an investment strategy appropriate for the fund and the charity.*" The Committee also explains, "[The] decision maker *must consider the charitable purposes of the institution* and the purposes of the institutional fund for which decisions are being made. *These factors are specific to charitable organizations.*"⁴

Another distinguishing feature of foundations and endowments is that they have a nonprofit purpose; they must provide a tax-exempt public benefit. Foundations and endowments are granted tax-exempt status on the basis of their providing a public benefit that will reduce the burdens on government and benefit society. The fiduciary duties of obedience to charitable mission and related obligations to serve a public benefit purpose require that fiduciaries of foundations and endowments consider their investment decisions in the context of these mandates.

Fiduciary Practices Evolve in Response to Changing Circumstances.

"There are no universally accepted and enduring theories of financial markets or prescriptions for investment that can provide clear and specific guidance to trustees and courts."

Restatement (Third) of Trusts § 227, comment (f)

While fiduciary principles remain constant, their application has been dynamic. Recent market downturns, including the dot-com bust of the early 2000s and the more recent Great Recession, raised questions about whether key 20th Century investment assumptions remain fit for purpose in the 21st Century. For example, the emphasis on short-term returns and the assumption that investors always act rationally fostered growing market volatility and unrecognized risk exposures that contributed to the massive losses which have been passed on to government and society.⁵ These 21st Century experiences have led to new thinking on investment principles.

In addition to evolution of investment theory, there have been global economic, societal and environmental developments that affect the sustainable delivery of the public benefits provided by foundations and endowments. They include:

- Climate change and global natural resource constraints (*e.g.*, adequate clean water and air) for economic activities;
- Economic and societal effects of reduced economic prosperity associated with stagnant wage growth and increasing income disparity;
- Collective market influence of institutional investors from the rising amount of assets they now manage, using very similar investment strategies;

³ Charitable mission means the specific goal of an entity contained in its organizational documents. Charitable or non-profit purposes are the required social benefits that non-profits are required to promote in order to be tax exempt. For a more detailed discussion of foundation and endowment fiduciary duties, see Johnson and Viederman, *The Philanthropic Fiduciary: Challenges for Non-Profits, Foundations and Endowments*, Cambridge Handbook of Institutional Investment and Fiduciary Duty (Cambridge University Press, 2014).

⁴ UPMIFA Drafting Committee Comment, section 3 (emphasis added).

⁵ James Hawley, Keith Johnson and Ed Waitzer, "Reclaiming Fiduciary Duty Balance," *Rotman International Journal of Pension Management* 4, no. 2 (fall 2011): 4-5.

- Increased investment industry competition over short-term returns, which began after the computerization of previously manual investment analysis and trading functions in the late 20th Century; and
- Massive movement of investment assets into passive market index strategies that detach investment decision making from analysis of sustainable company success.

Fiduciary principles have not changed, but they must be applied in such a manner as to reflect current economic, societal and environmental realities. Fiduciaries of foundations and endowments have an obligation to assess how their investment practices relate to their organization's charitable mission and public benefit purposes. For foundations and endowments with long-term or perpetual obligations, future needs must also be fairly balanced with short-term demands.

Managing Both Sides of the Non-Profit Balance Sheet.

An increasing number of foundations and endowments are responding to these challenges by cultivating a more contemporary approach to implementation of fiduciary duties. This has led them to a greater focus on holistic integration of program and investment policies to recognize their full range of fiduciary duties and to develop a more balanced investment approach that is consistent with the entity's charitable mission and public benefit purposes.

While divestment and portfolio screening were once seen as the only responsible investment options for foundations and endowments, current management techniques offer a diversity of approaches. These include integration of sustainability factors into investment analysis, exercise of proxy voting rights to support mission, engagement with company directors or management, sponsorship of shareholder resolutions, creation of new portfolios that offer equivalent investment diversity with mission consistency, and selection of external managers that use a mixture of these practices.⁶ The objective of these strategies is to generate competitive returns while better aligning investment management practices with each organization's charitable mission and public benefit purposes.

These developments allow nonprofit fiduciaries to balance management of both the program and asset sides of their entity's balance sheet. Many have begun to seek advisors with the expertise to answer three fundamental questions:

- What societal or systemic side effects and externalities⁷ are being fostered by their investment practices?
- Do the entity's investment practices undermine success in achieving its charitable mission and public benefit purposes?

"[The duty of obedience] requires the director of a not-for-profit corporation to be faithful to the purposes and goals of the organization, since unlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives."

Manhattan Eye, Ear and Throat Hospital v. Spitzer, 186 Misc. 2d 126, at 152 (NY, 1999)

⁶ For example, an organization with an environmental mission might choose to join with other investors or nonprofits to engage with portfolio companies about ways to reduce costs by adopting new practices that improve environmental performance and profitability. An entity with an educational mission might opt to support that mission by offering shareholder resolutions and/or voting shares on proxies to encourage company reporting on application of scientific evidence to future carbon risk exposures.

⁷ Externalities are the consequences of an economic activity that affects other parties without this being recognized in the cost or valuation of the activity.

- Are there investment strategies or practices which could better promote the entity's charitable goals?

While the fiduciary duty context for this approach is unique to each foundation and endowment, the basic fiduciary principles outlined above guide the process.

Philanthropic Fiduciary FAQs.

1. Is integration of program and investment practices the same as impact or social investing?

Absolutely not. Management of the entire balance sheet requires evaluation of investment practices to determine if they undermine charitable goals and to identify whether there are better options for management of investment of assets to further the organization's charitable mission and public benefit purposes.

2. Will integration of program and investment strategies reduce investment returns?

Not necessarily.⁸ Aligning program and investment practices requires foundations and endowments to work with their advisors to identify investment approaches that are most consistent with their charitable purpose and to use appropriate, usually long-term, timeframes for measuring investment success. Fiduciaries can select managers who employ a modern investment approach that seeks to generate competitive returns while minimizing the risks and future costs transferred to taxpayers or society.⁹

3. Does fiduciary duty require that nonprofits maximize current return on investment assets?

No. The UPMIFA drafting notes explicitly address this. Charities are required to use an investment strategy that reflects the financial needs, charitable mission and public benefit purposes of the entity over appropriate time frames. This fiduciary duty of obedience is specific to charities. Investment strategies developed for other entities might not be appropriate for foundations and endowments.

4. Is divestment of specific holdings a breach of fiduciary duty?

Fiduciaries are precluded from making investment decisions (whether related to selling, buying or holding) based on political or personal biases. They are also required to verify facts relevant to investment and management decisions. Where a fact-based analysis of investment risks, portfolio construction options and consistency with charitable purposes shows a reasonable basis for divestment of a holding, there could be an investment reason to sell it. Alternatively, some fiduciaries might determine that retaining a holding with a proactive strategy to engage the company or vote proxies is also consistent with their charitable mission and social benefit purposes.

5. Is management of the full balance sheet relevant to small investors?

Yes. Regardless of size, fiduciaries of foundations and endowments have the same obligation to use an investment strategy that is suitable for the fund and reflects its

⁸ Research on sustainable investing shows that managers with expertise in the integration of ESG factors into investment analysis can provide competitive returns and often outperform. For a summary of related studies, see <http://www.ceres.org/resources/reports/the-21st-century-investor-ceres-blueprint-for-sustainable-investing>.

⁹ Under s. 501 of the Internal Revenue Code, nonprofits are required to serve a public purpose. A 2012 comprehensive review of sustainability research by Deutsche Bank and Columbia University found that managers which integrate environmental, social and governance factors into investment analyses can provide superior risk-adjusted performance while engaging in responsible investment practices. See http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2222740.

charitable purposes. By collaborating with other organizations that have similar charitable goals, smaller foundations or endowments can achieve cost efficiencies and obtain access to expertise that is often available to only larger investors. For example, small investors can collaborate on engagement with companies, filing shareholder resolutions, developing proxy voting policies or conducting searches for service providers that offer investment services which fit their charitable missions.

6. Can fiduciaries have a portfolio that is both diversified and aligned with their charitable mission and social benefit purposes?

Yes. Even if an investor determines that specific investments would present unwanted risks or undermine charitable goals, advisors and managers with expertise in sustainable investment practices can often construct alternative portfolios that provide similar diversity, returns and benchmark tracking.¹⁰

7. What if our legal counsel vetoes an integrated investment management program?

Many legal and investment advisors still assume that the same legal standards and investment goals which pertain to other fiduciaries should be applied to foundations and endowments. While most of the same principles do apply, fiduciaries of foundations and endowments must also consider their charitable mission and public benefit purposes. Fiduciaries can conduct service provider searches to identify legal and investment advisors who are up to date with the evolving understanding of legal principles and investment management options.



Keith L. Johnson

Reinhart Boerner Van Deuren s.c.
22 East Mifflin Street
Madison, WI 53701
608-229-2231
kjohnson@reinhartlaw.com



Megan K. Jackson

Reinhart Boerner Van Deuren s.c.
22 East Mifflin Street
Madison, WI 53701
608-229-2241
mjackson@reinhartlaw.com

"In concert with the Foundation's mission to promote a sustainable and just social and natural system, we seek to invest our endowment assets in companies that:

- **Provide commercial solutions to major social and environmental problems; and/or**
- **Build corporate culture with concerns for environmental impact, equity and community."**

*Jessie Smith Noyes
Foundation Investment Policy*

This *Reinhart Institutional Investor Services E-Alert* provides general information and should not be construed as legal advice or a legal opinion. Readers should seek legal counsel concerning specific factual situations confronting them.

¹⁰ For example, see the MSCI analysis of different carbon risk reduction portfolio options at http://www.msci.com/resources/factsheets/MSCI_ESG_Research_Issue_Brief_Options_for_Reducing_Fossil_Fuel_Exposure.pdf.