

**Maximizing Public Confidence in Charities:
The Shared Challenge**

by
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I. Introduction:

- A. The title of my talk — "Maximizing Public Confidence in Charities: The Shared Challenge" — suggests four observations:
1. Public confidence in charities is not as high as it might be,
 2. It is possible to increase public confidence in charities by doing something,
 3. Not-for-profit organizations are among those which could do something, and
 4. Attorneys General and State Charity Officials are also among those which could do something.
- B. At an earlier date and in a different forum (i.e., at the Case Western Reserve Mandel Center on March 20, 1991), I spoke on a similar subject. A copy of that talk has been handed out here. The title then was "Diversity, Accountability, and Compliance in the Nonprofit Sector," and the theme was how the independent sector could — and should — encourage better regulation and accountability of *itself*. The audience then included no NAAG or NASCO folks. It comprised only leaders of the nonprofit sector. The reception then, while certainly not hostile, was — understandably — less than enthusiastic. People are not often enthusiastic about being told what they are not doing well, and what they might do better by undertaking certain duties and burdens beyond those they now carry. (It is one of the dubious benefits of academic tenure that a professor may take unpopular positions without imminent fear of reprisals.)
- C. Because I do not want to repeat the Mandel Center admonitions to the independent sector folks, today's talk will not focus on what the inde-

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pendent sector organizations could and should do to improve compliance by and regulation of nonprofit entities. Instead, it will concentrate on what NAAG/NASCO folks might do. Despite this change in focus, today's talk has at least three things in common with the Mandel Center speech:

1. It deals with the need for more regulation and accountability of the not-for-profit sector,
2. It argues that there is indeed something — or several things — that might be done to advance that goal,
3. It runs a severe risk of producing very low enthusiasm from the audience!

D. My talk today will be divided into two parts:

1. Some general observations about perceived weaknesses in the way state charity officials' offices advance "the shared challenge," and
2. Some specific observations about the current status of the Prudent Investor Rule and what state charity officials might do to improve the way in which charities manage their financial assets.

E. There will be time at the end of my remarks for questions, discussion, and debate. But — as a long-time devotee of the Socratic Technique — I am perfectly happy to take interruptions during the course of the talk. Folks interested in interjecting should just raise their hands. Furthermore, I am always aware of what Adlai Stevenson said at the start of a speech: "My job today is to talk. Yours is to listen. If you finish before I do, feel free to leave."

II. State Charity Officials' Offices and Regulation of Charities:

- A. By some counts, there are over 840,000 charitable (I.R.C. § 501(c)(3)) entities in the U.S.¹ Even with very substantial resources devoted to regulating them, it would be a daunting task to scrutinize continuously the activities of so many organizations.
- B. It is common knowledge that state charity bureaus are not blessed with very substantial resources, either of personnel or otherwise. A fair estimate would be that many such offices do not have any meaningful activity during a year, and — even among the most active (and resourceful) offices — staff and other resources are not adequate to undertake many of the programs and initiatives that could and should be undertaken. As I said, in the Mandel Center talk, "In most states, the Charity Bureau of the Attorney General's office is inactive, ineffective, understaffed, overwhelmed, or some combination of these." [Is everyone still having a good time?]
- C. This state of affairs — if the diagnosis is accepted at least arguendo — suggests the following strategies:
1. State charity officials should set their priorities to maximize their use of scarce resources, and
 2. State charity officials should get as much help as possible from outside people and organizations.

These two observations seem almost trite, but I will try to sharpen them. Of course, I don't know enough about the operation of any particular state charity bureau to presume to make specific recommendations

1. VIRGINIA A. HODGKINSON, MURRAY S. WEITZMAN, CHRISTOPHER M. TOPPE & STEPHEN M. NOGA, NONPROFIT ALMANAC 1992-1993, Tables 1.1 and 1.2 at pp. 23-24 (1992).

about resource allocation. Thus, these comments are intended only to provoke some consideration of a few options for action.

- D. Here are two suggestions for action, the first of which is both topical and precise, and the second of which is more general and ongoing:
1. In the wake of the United Way of America scandal, many local United Ways and many *other* charities have experienced lower levels of giving and higher levels of cynicism and disaffection. It would be helpful to the entire nonprofit community to reassure the general public that levels of executive compensation, in charitable organizations, are both reasonable and scrutinized. Attorneys General have a duty to police this area. How can it best be done?
 - a. Here is how *not* to do it: by supposing that state charity officials on their own can monitor the question effectively. I concede that such officials will and should take enforcement action in particular instances which in one way or another come to their attention. But I don't believe that available resources, or any level of realistically-conceivable future resources, will make it possible for state charity bureaus to monitor this issue effectively.
 - b. Here is one possible route to do it: bring together, under the auspices of the Attorney General, concerned leaders of the nonprofit sector, perhaps in a formal "Task Force" of some sort. After consultation and deliberations, invest in publicizing the initiative and the agreed standards that might emerge. Finally, recognize that even such standards are not likely to be enforced best by state charity bureaus

and — instead — look for an alternative process to monitor charitable compensation. I think that directors and trustees are the most likely group to regulate that process: it is, after all, their ultimate fiduciary duty to manage the affairs of their organizations.

This latter route, then, maximizes the use of scarce resources (i.e., the investment of time in participating in such a Task Force's work, and the investment of time and money in publicizing its outcome) and makes use of a great deal of help from outside people and organizations (i.e., the Task Force members in formulating standards, and directors and trustees in ongoing monitoring of the compensation issue). It should not matter to anyone that directors and trustees may cooperate not only out of genuine interest in the issue but also out of concern about (or fear of) liability for *not* measuring up to enunciated standards of care.

2. Building on the specific executive-compensation example, why not make the AG's office a convener for the charitable sector. Think about bringing together charity-sector leaders, under the auspices of state charity officials, to discuss accountability and regulation. Do not imagine that all of them will agree that more regulation and scrutiny are desirable, but — on the other hand — do not be so cynical as to believe that *none* of these leaders will respond in a constructive fashion. Suppose that, as a result, the charity bureau builds some good will with the sector? Or that, by getting to know more of the "players," it gets better sources of information about abuses which, once seen, can be corrected? Or that it finds out which specific issues matter most to the sector, and in what

ways state charity officials can improve their functions to promote as well as regulate such activities? It is my observation that much too little of this possibly-useful interchange goes on. It would not be very expensive of scarce resources to invest in trying the experiment of collegial discussion of issues. It might lead to interesting initiatives. It might enlist more outside effort to assist the state charity bureaus. It might even help to change some independent sector folks' occasional view of state charity officials as unfriendly policemen, and to realign that perception into one in which both the independent sector and state charity officials *share* the challenge of improved scrutiny, regulation, and accountability. (A "shared challenge": doesn't that sound like a good title for a talk?)

- E. A final thought: state charity officials might get support in "outreach" projects from several particular nonprofit organizations:
1. There is now a national association of state nonprofit organizations, with a full-time executive director in Washington, D.C. Many of the state umbrella organizations are now members of this new national umbrella group. I believe it would be interested in helping in projects looking to improvements in regulation and scrutiny of the sector.
 2. The National Center for Nonprofit Boards, the National Charities Information Bureau, and the Philanthropic Advisory Service of the Council of Better Business Bureaus all might be interested in cooperating in the effort. (And two out of three of these groups are represented here and will be heard from just after my talk.)
 3. There are now more than two dozen academic centers, at major colleges and universities, focussing on issues affecting the inde-

pendent sector. At least several of them include faculty from their law schools. Most belong to the Nonprofit Academic Centers Council (NACC), which this year is headquartered at the Mandel Center at Case Western Reserve University in Cleveland. They might be a further resource to tap. There are two monographs which describe each of these centers, with names and addresses of their directors.

III. State Charity Officials' Offices and the Prudent Investor Rule:

- A. Let's now change focus. I would like to talk about another issue: the way in which charities manage their assets, and particularly their financial assets. I will provide some historical observations, a brief review of recent developments, and a recommendation for action by state charity officials.
- B. First, some statistical and empirical background might be useful:
 - 1. Although data are extremely difficult to obtain, and to some degree suspect, the total financial assets owned by I.R.C. § 501(c)(3) organizations are probably in excess of \$150 billion.²

2. According to one estimate, in 1975 total assets of the organizations described in I.R.C. § 501(c) were estimated to amount to just over \$200 billion, of which just less than \$50 billion constituted financial assets. Gabriel Rudney, The Scope and Dimensions of Nonprofit Activity, THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 55, 61, Table 4.6 (W. Powell, ed., 1987). Using that ratio, i.e., that financial assets comprise about 23.7% of total assets, one can derive an approximate amount of aggregate financial assets from the estimate that, in 1988, total assets of I.R.C. § 501(c)(3) organizations amounted to approximately \$670 billion. VIRGINIA A. HODGKINSON, MURRAY S. WEITZMAN, CHRISTOPHER M. TOPPE & STEPHEN M. NOGA, NONPROFIT ALMANAC 1992-1993, Table 5.2, at p. 195 (1992). (The figure represents total assets of all organizations listed in the table, reduced by the assets of mutual benefit and foreign organizations.)

2. There is good reason to believe that the great bulk of charities woefully mismanage or undermanage their financial assets. For example, a recent study of the investment performance of *foundations*, which has been referred to as "a milestone" and "[t]he first comprehensive study ever done of foundation investment performance,"³ concludes in part as follows:

"While the overall rate of return on foundation assets exceeded the market averages, this was primarily because of the performance of the relative handful of larger foundations. In contrast, most foundations performed below the control portfolio.

"In fact, the rate of return the median foundation achieved was not sufficient to support a minimum 5-percent payout rate and still preserve the real, inflation-adjusted value of the asset base. . . .

"In addition, only a fraction of the foundation universe made use of an active investment management approach. . . . Investment management for a significant portion of the foundations consisted of turning the assets over to outside managers to be invested in low-risk, fixed-income securities."⁴

This criticism is directed at the investments of grant-making foundations, which are among the most financially sophisticated members of the nonprofit universe. If the investment practices of smaller service-providing nonprofit organizations were scrutinized, the results would certainly be even more dismaying.

3. L. SALAMON & K. VOYTEK, *MANAGING FOUNDATION ASSETS: AN ANALYSIS OF FOUNDATION INVESTMENT AND PAYOUT PROCEDURES AND PERFORMANCE* v (1989).

4. *Id.* at 53-54.

3. With more sophisticated and active management of assets, it is possible to achieve significantly higher rates of return over time. For example, major university endowments averaged a total compounded return of 13.2% per annum over the past ten years. These same endowments had an average of 51% of their portfolios invested in domestic and foreign equities as of mid-1991.⁵
4. If charities were able to achieve only a 4% average increase in total return on their financial assets, that would represent *\$6 billion more each year* for charitable purposes.

C. Historical Background.

1. The so-called "Prudent Man Rule" was born in Massachusetts more than 160 years ago. It was enunciated by Justice Putnam in Harvard College v. Amory.⁶ The facts of that case are fascinating, but we lack time to consider them. The case is remembered today for the words chosen by the court to describe the standard of care to be expected of trustees for charitable purposes:

"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 the probable income, as well as the probable safety of the capital to be invested."⁷

5. Both statistics come from confidential data compiled by Cambridge Associates and circulated only to universities and others subscribing to their services.

6. 26 Mass. (9 Pick.) 446 (1830).

7. Id. at 461.

The court was also very clear about whether charitable assets should be invested so as to put them at risk. In response to the argument that "manufacturing and insurance stocks are not safe, because the principal is at hazard,"⁸ the Court replied:

"It will not do to reject those stocks as unsafe, which are in the management of directors, whose well or ill directed measures may involve a total loss. *Do what you will, the capital is at hazard.* If the public funds are resorted to, what becomes of the capital when the credit of the government shall be so much impaired as it was at the close of the last war?"⁹

Thus, the inevitability of risk, and the need to manage it as a function of yield, was clearly recognized.

2. As set forth in 1830, the Prudent Man Rule involved no classification of stocks (or any other form of investment) as per se imprudent, adopting instead a flexible standard. Nevertheless, as the Rule later developed and aged — in cases, through legislation, and in scholarly commentary — its arteries hardened:
 - a. In 1869, for example, the New York Court of Appeals held that common stock investments were per se imprudent. King v. Talbot, 40 N.Y. 76 (1869).
 - b. Further, "[b]y 1900 both the majority of states and the great majority of trust funds were subject to ["legal list"] statutes."¹⁰

8. Id. at 460.

9. Id. at 461 (emphasis added).

10. BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 12 (1986).

- c. The first RESTATEMENT OF TRUSTS (in 1935) and the first edition of SCOTT ON TRUSTS (in 1939) rephrased and elaborated on the Prudent Man Rule. Because of the extraordinary influence of Scott's scholarship — he was the Reporter for the Restatement as well as the author of the Treatise — his words and examples had a force which is difficult to exaggerate. These were carried forward without any significant change into the second RESTATEMENT in 1959, and through two subsequent editions of his Treatise (the latter of which is dated 1967). Scott's exegesis of the Rule was in many ways more constrained than Justice Putnam's.

These developments are well cataloged in several useful articles.¹¹

D. Recent Developments:

1. In the early 1980's, legal counsel for four major universities decided to undertake a study of the proper management of charitable endowments. Their proposal, with support from five leading foundations, led to a study headed by Bevis Longstreth, a New York City attorney and former Commissioner of the SEC. That study, in turn, produced a book: BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE (1986). I rec-

11. See, e.g., Gordon, The Puzzling Survival of the Constrained Prudent Man Rule, Appendix B, BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 195 (1986), also later republished in substantially identical form as Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U.L. REV. 52 (1987). Also see Haskell, The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory, 69 N.C.L. REV. 87 (1990).

commend it as extremely useful reading by state charity officials for two reasons:

- a. It contains a very clear and very interesting discussion of both legal and financial developments in the management of financial assets by charities, and
- b. It was responsible for catalyzing important parts of the next steps in recent developments in the area: among its major recommendations was "that the American Law Institute undertake a new restatement of the law of fund management by fiduciaries" ¹²

2. The American Law Institute responded favorably. The result was, indeed, a new and superseding restatement of the law of fund management, published this year: *RESTATEMENT OF THE LAW THIRD, TRUSTS (PRUDENT INVESTOR RULE) (1992)*.¹³ (Note the elimination of the older 1830 gender bias in the title of the rule!) This should be a mandatory acquisition for reading and research by all state charity bureaus . . . assuming they have the budgetary resources to purchase a copy.

3. The new Prudent Investor Rule contains some surprises for those who have not been following developments in modern investment management. Among them are three points which I want to emphasize:

- a. *First point* — There are no investments which are imprudent or suspect per se. Indeed, it is quite improper to

12. *Id.* at 158.

13. Hereinafter cited as "RESTATEMENT 3D."

approach that question on an investment-by-investment basis. Rather, to quote the new rule, the standard of care:

"is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust."¹⁴

As the Reporter's Comments clarify, "[s]pecific investments or techniques are not per se prudent or imprudent."¹⁵

Thus, the following are all permissible and potentially quite prudent, in the context of an overall portfolio strategy:

trading in options, investing in domestic and foreign equities, buying real estate or second mortgages, engaging in venture capital transactions, holding oil or gas interests, investing in commodities and foreign currency, and writing puts, calls, or other options.¹⁶ The IRS, after waffling on one aspect of this issue,¹⁷ has confirmed that charitable

14. RESTATEMENT 3D § 227(a).

15. RESTATEMENT 3D, Comment § 227(f)(2) at p. 24.

16. The Official Comments state that "there is no arbitrary barrier to the competent use, in proper roles and circumstances, of options and futures transactions or of programs for investing in foreign markets, real estate, or unestablished enterprises." RESTATEMENT 3D at 42-43.

17. In LTR 9042038 (July 23, 1990), the IRS ruled that no UBIT problem arose from an interest rate swap. But then in LTR 9046066 (Nov. 16, 1990), the Service announced that it was reconsidering LTR 9042038. Eight months later, in LTR 9136037 (Aug. 28, 1991), it withdrew LTR 9046066, thus in effect reinstating the no-problem conclusion of the first private letter ruling. It also issued Announcement 90-134, 1990-50 I.R.B. 18 (Dec. 10, 1990), indicating that it would promulgate regulations on the subject.

organizations may invest in interest-rate swaps and other notional principal contracts without incurring tax under the unrelated business income tax provisions of the Internal Revenue Code. Final regulations on this subject were adopted July 29, 1992, and explicitly except from UBTI:

"income from notional principal contracts (as defined in Treasury Regulations 26 CFR 1.863-7 or regulations issued under section 446), [and] other substantially similar income from ordinary and routine investments . . ."¹⁸

- b. *Second point* — The key to prudence is process. Once the decision is taken that investments may not properly be judged separately, but rather only as part of an overall portfolio, the prudent-investor standard requires that prudence be measured by the manner in which the overall portfolio is analyzed and fixed by the charitable organization. As quite clearly stated by Bevis Longstreth:

"The key to this approach is process. Prudence is to be found principally in the process by which investment strategies are developed, adopted, implemented, and monitored in light of the purposes for which funds are held, invested, and deployed. Prudence is demonstrated by the process through which risk is managed, rather than by the definition of specific risks that are imprudent."¹⁹

18. Treas. Reg. § 1.512(b)-1(a)(1), adopted by T.D. 8423, 57 Fed. Reg. 33442 (July 29, 1992).

19. BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 7 (1986).

The combination of these first two points contains some good news for sophisticated charitable organizations: they are permitted much more flexibility in investment management, so long as they engage in the proper processes to make overall portfolio decisions. The introduction to the RESTATEMENT 3D confirms that one of its objectives is "liberating expert trustees to pursue challenging, rewarding, non-traditional strategies when appropriate to the particular trust"20 As we will see in just a moment, however, these first two points also contain some *bad* news for some charitable organizations.

- c. *Third point* — Delegation of investment discretion is permissible, and often very desirable. This is further good news to counter the occasional bad news from the prior two points. Consider now the *bad* news from the first two points: because process determines prudence, and investment management and analysis is a quite complex undertaking, many smaller-and-less-sophisticated charities will be hard pressed to meet the new standard. (I should emphasize that, under the new Prudent Investor Rule, directors and trustees cannot find protection merely by putting all of the charity's assets into certificates of deposit or U.S. Treasury obligations. Not only is no investment, taken alone, per se *imprudent*, but no investment, taken alone, is per se

20. RESTATEMENT 3D at 5.

*prudent!*²¹⁾ Thus, it is very helpful that the Restatement also provides:

"A trustee has a duty personally to perform the responsibilities of the trusteeship *except as a prudent person might delegate those responsibilities to others.*"²²

The official comments add that "the trustee has power, *and may sometimes have a duty*, to delegate" ²³ This reaffirms what is already the law in many states, under section 5 of the Uniform Management of Institutional Funds Act.²⁴ Careful delegation of investment management will help protect charitable assets from mismanagement or undermanagement, and is consistent with a second major objective of the Restatement, i.e., "that of providing other [non-expert] trustees with reasonably clear guidance

21. As the Official Comments point out, "All investments, even the nominally excepted short-term U.S. Treasury securities, and all investment strategies involve some risk in the comprehensive sense of possible loss of real, inflation-adjusted value." RESTATEMENT 3D at 18.

22. RESTATEMENT 3D § 171 (emphasis added).

23. RESTATEMENT 3D at 38 (emphasis added). See also *id.* at 16.

24. Section 5 of UMIFA has been adopted, with occasional minor changes, in 40 states. As a result, a broad survey of fiduciaries concluded:

"Delegation of investment authority, a major legal stumbling block before statutory and regulatory reforms over the last fifteen years, is both widespread and apparently unproblematic for the great majority of fiduciaries A significant proportion of those . . . fiduciaries have retained consultants to assist in selecting investment managers." BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 154 (1986).

to safe harbors that are practical, adaptable, readily identifiable, and expectedly rewarding."²⁵

E. Recommendations for Action:

1. State charity officials should carefully consider the new Prudent Investor Rule and the principles of Modern Portfolio Theory, and should put forth statements endorsing them. In many states, there will be no need for changes in statutes, but in some cases legislation may be required.²⁶ In *all* states, charities will look primarily, even if not exclusively, to the Attorney General's office to enunciate the standards to which trustees and directors will be held in managing their financial assets. It will be extremely helpful for state charity bureaus to publicize these standards, widely and repeatedly, for two reasons: to give comfort to those trustees and directors who desire to use the greater investment flexibility afforded by the new Rule, and to raise the consciousness of those other trustees and directors who may be unaware of their opportunities and duties under the new Rule.
2. State charity officials should undertake a general educational program — via publications, speeches, and otherwise — to focus charities on the need to manage their financial assets better. Many

25. RESTATEMENT 3D at 5.

26. Illinois and Virginia are leaders here. Illinois adopted the new Prudent Investor Rule in September 1991, effective January 1, 1992. Illinois P.A. 87-715 (1991), codified at 17 Ill. Rev. Stat. ¶¶ 1675, 1675.1, and 2103. Virginia also enacted it in 1992, Va. Code Ann. § 26-45.1. Professor John Langbein, of the Yale Law School, is working on a Uniform Prudent Investor Act, under the auspices of the Commissioners on Uniform State Laws. The Act may be promulgated in early 1995, if all necessary prior approvals occur on schedule.

independent sector organizations will be willing to cooperate in this effort, given leadership by the Attorney General's office. This will create new opportunities for working together on the shared challenges facing the sector. To the extent the educational program is successful, it will also help to provide more funds for the critical charitable needs of our society.