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When the Endowment Tanks: Some Lessons for Nonprofits

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SOME LESSONS FOR NONPROFITS

By Jeffrey Haas

While most individual investors have been busily licking their portfolio wounds the last two years, another group of nervous investors has gone largely unnoticed until now. As reported late last year in the *New York Times* (Nov. 5, 2002), this group is comprised of directors and trustees of colleges, universities, hospitals and other charitable institutions.

Like their retail investor counterparts, many of these directors and trustees have watched in dismay as their endowment funds have declined over the past two years. With respect to college endowments, for example, two out of every three fell in value during fiscal year 2001, with the average decline pegged at 3.6 percent. The numbers for fiscal year 2002 appear worse, with preliminary data showing an average decline of 5.4 percent.

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These declines may not elicit sympathy from investors negatively affected by the implosions of Enron, WorldCom, Tyco and certain other high fliers of the late 1990s. Nevertheless, given the conservative veneer of most endowments, these declines are, in fact, highly significant — especially when examined historically.

Indeed, the fiscal year 2001 decline in college endowments was the first since 1984, and one must look back to the early 1970s for the last time they lost value two consecutive years. All in all, billions of endowment dollars have been lost, most probably for good.

The timing of these declines, moreover, could not have been worse. With wealthy donors dramatically scaling back their charitable giving in response to falling stock prices and a weakened economy, capital campaigns and other fund-raising activities are unlikely to make up the shortfalls.

This is truly unfortunate because many nonprofits withdraw funds from their endowments each year to supplement their operating budgets. For example, many college endowments average their endowment values for the last three years and then take a percentage (often around 5 percent) of that value for use in normal business operations. As a result, many nonprofits are facing an actual loss in the contribution to their operating funds for the first time in a generation. Those depending on nonprofits — students, alumni, patients, doctors and communities generally — likewise will suffer.

Had a level investment playing field existed over the last few years, nonprofit directors and trustees simply could shrug off the declines and move forward. This, however, was not the case. Some public companies cooked their books, misstating their true financial positions and misleading investors — including endowment funds — in the process. Additionally, some of Wall Street's leading financial institutions apparently used a flawed business model that placed their own desire for outsized profits ahead of clients' needs.

In light of recent events, it behooves nonprofit directors and trustees to conduct a soup-to-nuts review of their endowments' investment policies and the implementation of those policies over the last few years. Were investments overly concentrated in violation of those policies? Were investments made in companies tainted by accounting fraud that were ultimately sold at a loss? Were investment decisions made

Jennifer Kalis

based on deceptive investment advice?

To the extent the review reveals fraudulent misconduct, directors and trustees should consider pursuing available legal avenues to recover losses rather than simply shrugging their shoulders and wringing their hands.

This advice is no doubt alien to many of those operating within the gentlemanly and lady-like world of nonprofits. Because confrontation is often distasteful and, in the context of a nonprofit, virtually unexpected, it is worth asking the following important question: Does the law require nonprofit directors and trustees to conduct a full endowment review based on recent events? While the simple answer to this question is yes, there is more to the story.

As is the case for directors of for-profit corporations, state not-for-profit corporate law recognizes that the buck stops with nonprofit directors and trustees. Because many view themselves as having been recruited for their ability to raise or contribute funds rather than for their managerial prowess, this could come as a surprise.

Nonprofit directors and trustees, however, simply do not operate in an "advisory" role, leaving the tough decisions to senior officers. Indeed, according to Professor Harvey Goldschmid (now SEC Commissioner Goldschmid) of Columbia Law School, many have "false comfort" in that they "assume that a little governance activity and a lot of fund raising will suffice" in satisfying their legal obligations.

Historically, a nonprofit director's conduct was measured by the exacting standards applicable to a trustee of a trust. Those standards prevented a trustee from engaging in a self-dealing transaction, whether or not beneficial to the trust. They also prevented a trustee from delegating authority over investments. Moreover, a trustee's standard of care was based on concepts of ordinary or simple negligence, rather than gross negligence.

Fortunately, the law no longer holds a nonprofit director or trustee to such exacting standards. Instead, a nonprofit director's conduct is governed by standards applicable to for-profit directors. Thus, the fiduciary duties of care and loyalty apply as equally to nonprofit directors as they do to for-profit directors. Moreover, most states provide nonprofit directors and trustees the presumptive protection of the business judgment rule. Thus, those suing nonprofit directors or trustees will have to proffer evidence overcoming the presumption that the directors or trustees have, in fact, acted in good faith and with due care and with the best interests of the nonprofit in mind.

Yes, confrontation is distasteful.

With respect to the duty of care, the nonprofit standard of most states parrots their for-profit analog. In New York, for example, nonprofit "[d]irectors and officers [must] discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent [persons] would exercise under similar circumstances in like positions."

The "prudent person" is designed to be a generalist with the ability to select and evaluate senior officers, oversee and evaluate corporate performance, review and approve major corporate plans and actions, and perform other functions normally performed by for-profit directors. The terms "similar circumstances" and "like position" are designed to take into account the nature, size and complexity of the nonprofit, the magnitude of its problems, and the individual role of a director when ascertaining whether that director has satisfied his or her duty of care.

Have the actions of nonprofit directors and trustees generally lived up to this standard of care? At least one commentator believes that, in many instances, the answer is no. According to Mr. Goldschmid, the duty of care is designed to encourage "accountability and activity, far more activity than is generally seen in nonprofit board rooms."

In the context of investment decisions, most states have adopted the Uniform Management of Institutional Funds Act (UMIFA). Under Section 5, the board of an eleemosynary institution may delegate day-to-day investment management authority to committees or employees. It also may purchase investment advisory or management services.

When directors delegate investment management duties, Section 6 of UMIFA requires directors to consider the long and short term needs of the corporation in carrying out its purpose, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.

Despite statutory authority to delegate investment management duties, responsibility for investment policy and selection of competent agents remains firmly with the board. A board simply cannot delegate investment authority and then turn a blind eye to the investment performance of its endowment fund. A director's general duty to protect the nonprofit from actual or perceived harm, including harm caused by those to whom investment authority has been granted legitimately, prohibits this.

Indeed, William Josephson, New York's assistant attorney general in charge of the Charities Bureau, recently wrote that "[t]he duty of care requires that trustees, directors and officers . . . be attentive to the organization's activities and finances and actively oversee the way in which its assets are managed. . . . This includes . . . ensuring that funds are properly managed, asking questions, and exercising sound judgment."

As Mr. Josephson's statement makes clear, the duty of care requires boards to make reasonable inquiries whenever circumstances warrant. Given the seemingly never-ending news reports of accounting mismanagement at many public companies, the boundless conflicts of interest affecting stock-analyst research and the other misdeeds occurring on Wall Street, has there ever been a larger red flag waving before the eyes of nonprofit directors and trustees? At a minimum, those whose endowments have declined must determine whether the declines occurred unnecessarily as a result of others' misdeeds.

Boards, of course, are legally entitled to rely on information, opinions, reports and statements prepared by officers, counsel, public accountants, other advisers and board committees. Such reliance, however, must be in good faith. If a director or trustee has knowledge of a problem affecting the investment management or portfolio securities of his or her endowment, that director or trustee should conduct a thorough investigation to see if the endowment's performance has been harmed.

If directors or trustees uncover malfeasance as part of their inquiry, they should consider pursuing available legal avenues to recover losses. If, for example, investments were overly concentrated, directors and trustees should consider legal action against the investment adviser. While certainly not an insurer of its client's investments, an investment adviser whose investments were negligently and improperly made at the outset could face liability.

Directors and trustees also could sue the companies in which their endowments invested. The University of California public university system lost $145 million by investing in Enron. Breaking with tradition, trustees took the fight to those it blamed for this staggering loss. The system has become the lead plaintiff in a 500-page lawsuit that names Enron's directors and senior officers, its public auditors, nine banks and two law firms with fraud.

Will nonprofit directors or trustees incur personal liability for sitting on their hands when the law requires action? Theoretically, the answer is yes — but practically speaking, the answer is no in most instances. This conclusion stems from an analysis of both the business judgment rule and statutory provisions regarding standing to sue.

Nonprofit directors and trustees enjoy the presumptive protection of the business judgment rule in most states. This protection is particularly important in the context of a nonprofit corporation because many not-for-profit corporate codes do not allow nonprofit corporations to adopt exculpatory charter provisions.

Overcoming the presumption that directors or trustees acted in good faith, with due care and with the best interests of the nonprofit in mind is an uphill battle for anyone with standing to sue. This is especially true in states that employ a gross negligence standard of care.

In the context of the duty of loyalty, however, the business judgment rule is disabled whenever a plaintiff proffers evidence of directorial self-interest. In *Scheuer Family Foundation Inc. v. 61 Associates* (582 N.Y.S.2d 662 (N.Y. App. Div. 1992)), for example, a former director of the foundation sued the remaining directors claiming they negligently selected, supervised and monitored the foundation's investment adviser. The defendants filed a motion to dismiss based on the business judgment rule, but the court refused to grant it because one or more directors also worked at, or had personal investments in, that investment adviser.

In terms of standing to sue, nonprofits have no shareholders to bring traditional derivative lawsuits. Nevertheless, the not-for-profit law of most states points to three potential plaintiffs in a suit against nonprofit directors or trustees.

The first is another nonprofit director, trustee or officer suing derivatively on behalf of the nonprofit. Such suits, however, are unlikely to occur unless what is being alleged is directorial disloyalty or self-dealing.

The second potential plaintiff is one or more members of a membership nonprofit suing derivatively on behalf of the nonprofit. Such a plaintiff has the potential to become a potent force for ensuring directorial adherence to fiduciary standards, but only in the context of membership nonprofits and not others.

The third and most likely potential plaintiff is a state's attorney general. The attorney general has the *parens patriae* power to protect the interest of the public with respect to assets pledged to public purposes, as well as the statutory authority to commence investigations into and legal actions against nonprofit directors and trustees.

Specifically, a state's attorney general can sue directors and officers for breach of fiduciary duties, including mismanagement and waste of corporate assets. Indeed, Mr. Josephson views the New York attorney general "as the enforcer of the duties of care, loyalty and obedience." In this context, the attorney general would be representing the interests of the state in seeing nonprofits succeed.

History indicates, however, that it is unlikely for any of these potential plaintiffs to sue nonprofit directors or trustees for failing to investigate the decline in their organization's endowment. Mr. Goldschmid attributes a lack of litigation in the nonprofit area generally to the forbearance by state charity regulators due to understaffing.

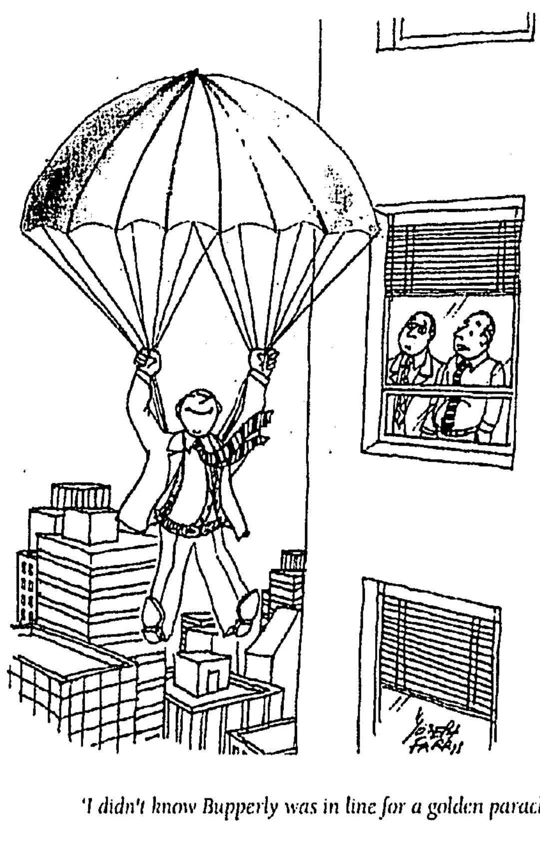
A puzzlingly paradox, therefore, permeates the nonprofit world. As explained by Mr. Goldschmid, "nonprofit directors and officers generally operate under the same state fiduciary standards as their for-profit peers, but, in contrast to the for-profit world, fiduciary duty law plays little role in assuring accountability in the nonprofit sector. . . . Highly restrictive standing rules and a lack of governmental enforcement have made the duty of care and duty of loyalty standards almost wholly aspirational in the nonprofit sector."

This all leads to two conclusions.

First, directors and trustees of nonprofits have a legal duty to investigate the decline in their endowment funds given the unprecedented events in the capital markets. Second, this duty is unlikely to be enforced against them if they fail to do so.

But simply because that duty is unlikely to be enforced does not undermine its existence. The policy behind the duty is sound given how important endowments are to the survival of many nonprofits.

Directors and trustees, therefore, need to recognize their moral obligation to protect the organizations they serve regardless of whether their legal duty to do so is enforced. Nonprofits simply are too vital to their constituencies and the communities in which they operate for their directors and trustees to sit passively on the sidelines. BLT



'I didn't know Bupperly was in line for a golden parachute!'

POSITION ANNOUNCEMENT

ASSISTANT FEDERAL DEFENDER

NORTHERN DISTRICT OF INDIANA
FEDERAL COMMUNITY DEFENDERS, INC.

NORTHERN DISTRICT OF INDIANA FEDERAL COMMUNITY DEFENDERS, INC., a non-profit private corporation funded by the Administrative Office of the U.S. Courts, is accepting applications for the position of assistant federal defender to be stationed in the Hammond office. The federal defender organization operates under authority of the Criminal Justice Act, 18 U.S.C. § 3006A, to provide defense services to individuals charged with federal criminal cases and related matters, who are financially unable to retain counsel.

Requirements. An assistant federal defender must be: (1) a graduate of an accredited law school, and admitted to practice in good standing before the highest court of a state; (2) licensed to practice in the U.S. District Court for the Northern District of Indiana; and (3) licensed to practice law in a state bar. The applicant must be willing to become licensed in the State of Indiana within one year of the appointment. Appointment may be subject to a satisfactory background investigation.

Duties. The assistant federal defender will represent clients charged with federal criminal offenses, including trial, appellate and ancillary matters. The position requires considerable travel for investigation, litigation, and training. Assistant federal defender may not engage in the private practice of law.

Selection Criteria. The successful applicant will have an established capacity or clearly demonstrated aptitude for excellence in criminal defense practice, a commitment to the representation of indigent accused persons, and a reputation for personal integrity. Experience in handling federal criminal cases and trial experience are preferred.

Salary. The salary of an assistant federal defender is commensurate with that of an assistant U.S. attorney with similar qualifications and experience.

How to Apply. Qualified persons may apply by forwarding a letter of interest, résumé, and representative writing sample marked "Confidential" to: Personnel Officer, Northern District of Indiana Federal Community Defenders, Inc., P.O. Box 667, Hammond, Indiana 46325-0667. No phone calls please. Position announced March 17, 2003; applications accepted until May 17, 2003.

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