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AUTHOR	Blackwell, Thomas E.; Johns, Ralph S.
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ABSTRACT

In 1968 the Ford Foundation appointed an Advisory Committee on Endowment Management to study the management of college and university endowment funds with an eye toward the accounting and legal principals of more unconventional investing. The Committee concluded that gains from endowments need not be treated as principal of NACUBO sees this doctrine as being erroneous because it arises out an incomplete reading of the conflicting historical legal opinions regarding charitable trusts and faculty interpretations of those opinions. The evidence presented shows that colleges and universities must retain realized endowment gains as principal. The controversy continues into a discussion of whether the college or university holds the funds as absolute owner or as trustee, and the accounting principals that must be applied in each case as well as the implications of each argument. Additionally, the discussion continues to whether or not realized gains from an endowment should be treated as income or capital gains for accounting and tax purposes. NACUBO looks for a conclusive court ruling in some future test case to prove the legitimacy of their arguments. (JMF)

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COLLEGE ENDOWMENT FUNDS: A CONSIDERATION OF APPLICABLE ACCOUNTING AND LEGAL PRINCIPLES

By THOMAS E. BLACKWELL, *Publisher*
The College Law Digest
Santa Monica, California

RALPH S. JOHNS, *Partner*
Haskins & Sells
Chicago, Illinois

McGeorge Bundy, President of The Ford Foundation, on pages 7 and 8 of his 1967 Annual Report, said:

> We recognize the risks of unconventional investing but the true test of performance in the handling of money is the record of achievement, not the opinion of the respectable. We have the preliminary impression that, over the long run, caution has cost our colleges much more than imprudence or excessive risk taking.

Ford Initiates Management Study

In 1968 The Ford Foundation announced the appointment of an Advisory Committee on Endowment Management, with Robert R. Barker, a member of the investment firm of William A. M. Burden & Company as chairman, to study the management of college and university endowment funds. William L. Cary, a member of this committee and of the faculty of the School of Law of Columbia University, began a survey of the law governing endowment funds. He submitted the report of this study, entitled *The Law and the Lore of Endowment Funds*, prepared in association with Craig B. Bright, a member of the legal firm of Patterson, Belknap & Webb, to The Ford Foundation and it was published during April of 1969 as the first of the Foundation's "Educational Endowment Series." Because of the probable impact of this report upon the thinking

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THE CONCEPT of total return on investments has been widely examined since publication a year ago of The Ford Foundation's The Law and the Lore of Endowment Funds. *The concept is familiar by now to most business officers with responsibilities for investment, yet many believe that there are legal as well as philosophical adjustments to be made if total return is to become the investment mode. The accompanying article, the work of two men who are exceedingly well versed in investment policy and law (see page 3), fills in the legal-philosophical background of traditional practice and suggests the importance of legal considerations to institutions trying to determine their own lines of action. NACUBO welcomes this contribution of Dr. Blackwell and Mr. Johns to discussions of the total return idea. If there is more to be said, NACUBO awaits the saying. Meantime, business officers are urged to review laws of their own states, if they have not done so, to see what limitations may exist. And those interested in further reading may wish to follow up the citations of this article and those of the Ford reports, including specifically, perhaps, certain chapters of* Higher Education in the United States, *Seymour E. Harris, Editor (Harvard University Press, 1960).*

of those concerned with the administration and governance of our institutions, it should be widely read and discussed. The following is from page 33:

> We are thus led to the conclusion that there is no substantial authority under existing law to support the widely held view that the realized gains of endowment funds of educational institutions must be treated as principal.

To understand how it was possible for two distinguished legal scholars to reach such a conclusion—which they admit is directly contrary to the widely held view on the subject—one should review the history of the development of the law of charitable trusts. If the courts of this country had always been of the opinion that colleges, universities, and other charitable corporations hold their endowment and other restricted funds as trustees and not as absolute owners, no one could challenge the corollary that such endowment funds are, in fact, charitable trusts, to be administered in accordance with long-established concepts of the law of trusts. A primary rule of the law of trusts is that realized gains of trust funds must be treated as principal and not as income to be expended.

Unfortunately, the Supreme Court of the United States came to the erroneous conclusion in 1819 *(1)* that it was not possible to create a charitable trust unless the state in which the donor was domiciled had accepted an early English statute *(2)* as part of its common law. *(3)* When better historical material had been made available for judicial consideration, the Supreme Court repudiated this doctrine and came to the conclusion that charitable trusts are not dependent upon statutory authority for their validity and that the law of charitable trusts is now an integral part of our common law. *(4)*

New York Ruling Of 1866 Cited

A substantial number of the state courts have consistently adhered to this more enlightened view of the Supreme Court. *(5)* However, in 1866, the Appellate Division of the New York Supreme Court refused to uphold the validity of a charitable trust on the ground that statutory authority was necessary to permit their creation and, since the legislature, in revising the New York statutes in 1828, had failed to mention charitable trusts, they could not be granted legal recognition. *(6)* The court also justified its decision with the argument that it would be better public policy to compel those desiring to dedicate funds to charitable or educational purposes to give them to a corporation to be created by a special act of the legislature. The legislature, by refusing to grant the privilege of incorporation to those planning to devote funds to purposes considered undesirable, could thereby exercise a degree of public control in this area.

The courts of New York and those in other states influenced by them continued to follow this line of reasoning for many years. This doctrine, that only a charitable corporation should be permitted to hold and administer funds designated for educational and other charitable purposes, soon included the concept that a gift or bequest to a charitable corporation for the establishment of a permanent endowment did not create a charitable trust, even though the words "in trust" were used in the instrument of gift. *(7)*

On the other hand, the Supreme Court of Wisconsin refused to adopt this strange doctrine on the ground that it was contrary to sound legal reasoning and that its general acceptance would have an adverse effect upon the willingness of donors to continue to make generous gifts and bequests to our colleges and universities. The following is from the opinion of the court: *(8)*

> It seems highly improbable that the testatrix had in mind the giving of this splendid donation in such a way that it might be dissipated or disposed of for any purpose the city saw fit as soon as it came into possession of the property. It is likewise improbable that the donation would have been made had the donor understood that any such result could legally follow.

However, due to the large volume of litigation in the State of New York, the numerical weight of judicial opinion during this early period firmly supported the following

THOMAS E. BLACKWELL, retired Vice Chancellor of Washington University, has been interested for years in the legal aspects of educational administration including management of investments and endowments. His doctoral thesis at Washington University was on "The Charitable Corporation and the Charitable Trust," a study later published in the former Financial Advisory Service *of the American Council on Education. He was editor of the two-volume edition of* College and University Business Administration *published by the ACE in 1952 and 1955, and he is the author of a number of books including* College Law. A Guide for Administrators *(ACE), 1961;* College and University Administration, *1965, and* College Law Manual, *1968. In January, 1970, he initiated publication of a specialized quarterly,* The College Law Digest, *an information service for college and university administrators and their attorneys. He is an associate member of the National Association of College and University Attorneys and a member of its Committee for the Exchange of Legal Information.*

RALPH S. JOHNS, a member of the firm Haskins & Sells since 1943, is known throughout NACUBO for his contributions to the development of college and university accounting principles and is otherwise recognized nationally for his leadership, writing, and participation in professional affairs. He is a former member of the Council of the American Institute of Certified Public Accountants, and among his many AICPA activities are his chairmanship of the Institute's Committee on College and University Accounting and his service as AICPA representative on the Revision Committee for Volumes I and II of College and University Business Administration. *He is author or co-author of a number of books and articles on college and university accounting and on plans for pooling investments of endowment funds.*

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comment of Austin Wakeman Scott, editor of the first restatement of the law of trusts in 1935 in his Introductory Note: *(9)*.

> Where property is given to a charitable corporation, a charitable trust is not created, even though, by the terms of the gift, the corporation is directed to hold the principal forever and to devote the income only to the accomplishment of the purposes of the corporation, and even though, by the terms of the gift, the corporation is directed to use the property only for a particular one of its purposes.

Adverse Effect On Giving Feared

Shortly after the publication of the first restatement of the law of trusts, a division of the New York Supreme Court ruled that a charitable corporation could use its endowment funds for any corporate purpose and that neither the state nor the donor's representatives could interfere to require a strict compliance with the donor's expressed intentions. An article in the *Minnesota Law Review* pointed out the probable adverse effect this decision would have upon future gifts for educational and other charitable purposes. *(10)*

Upon appeal, the judges of the court came to the conclusion that it was time to reject the old New York doctrine. Judge Finch, speaking for the majority of his brethren on the bench, said: *(11)*

> The charitable corporation is not bound by all the limitations and rules which apply to a technical trustee. It may not, however, receive a gift made for one purpose and use it for another, unless the court, applying the cy pres doctrine, so commands.

In referring to the equitable doctrine of cy pres, a concept deeply embedded in the law of charitable trusts, *(12)* the court gave clear indication that those responsible for the administration of the endowments of colleges and other charitable corporations should now be guided by trust law and not by corporate law.

In an annotation to this case, one of the editors of the *American Law Reports* made this comment: *(13)*

> Inasmuch as New York has long since had a statute which permits the creation of charitable trusts, the continued adherence to the view that no trust is created by a gift to a charitable, religious, or educational corporation may be somewhat embarrassing to the New York courts as in St. Joseph's Hospital v. Bennett, in which the minority have great difficulty in seeing how the gift can, at the same time be "absolute," and yet subject to enforceable restrictions on its use.

The *Columbia Law Review* made the following comment on this case: *(14)*

> The decision is of practical importance to a host of heavily endowed universities and other charitable organizations and is a substantial clarification of what has heretofore been a moot and disturbing point in this state and in others affected by its decisions.

Terms of Gift Held Enforceable

Thus ends a long and unhappy chapter in the history of the law. It is significant that Professor Scott, serving again as editor of the second restatement of the law of trusts, published in 1959, omitted the Introductory Note in the first restatement to the effect that charitable corporations do not hold their restricted funds as trustees. Instead, we find the following: *(15)*

> Where property is given to a charitable corporation and it is directed by the terms of the gift to devote the property to a particular one of its purposes, it is under a duty, enforceable at the suit of the Attorney General, to devote the property to that purpose. Where property is given to a charitable corporation and it is provided by the terms of the gift that it retain the principal and devote the income only to the accomplishment of its purposes or one of its purposes, the corporation is under a duty, enforceable at the suit of the Attorney General, to retain the principal and to use the income for the designated purpose.

The use of this language, taken from the terminology of trust law, is consistent with the assumption that charitable corporations have a fiduciary responsibility in the administration of their restricted funds. It is true, of course, that there a few important legal distinctions between the duties of the governing board of a charitable corporation and those of individual trustees of charitable trusts. For instance, a charitable corporation, upon receipt of a bequest for the establishment of a scholarship fund, was not required to seek appointment and to qualify as a trustee by giving bond to the probate court. *(16)* The rationale is obvious; a charitable corporation is chartered by the state to accept and administer funds for the benefit of the public and it would be absurd for a court to require it to qualify as a trustee every time it received a gift or bequest for this purpose.

Messrs. Cary and Bright, on pages 15 and 16 of their report, cite the St. Joseph Hospital case as upholding the old New York doctrine. It is suggested that they re-read the opinion of the court in the light of the history of the origin of this erroneous doctrine. They should read what Professor Scott had to say on this subject in his text on the law of trusts. *(17)*

On page 68, note 15, they state that Wisconsin has now adopted the absolute ownership theory, citing the case of *Estate of Berry*, 29 Wisc. 2d 506; 139 NW 2d 72 (1966) as authority. A more careful analysis of the opinion of the court in this case should convince them that there has been no change in the attitude of the Wisconsin Supreme Court in this regard. The court merely explained the distinction between a testamentary trust, in which there must be an accounting by the trustee to the court, and a charitable trust held by a charitable corporation, from which no such accounting is required.

Messrs. Cary and Bright are correct in their conclusion that the courts of this country have not yet been called upon to rule on the specific question as to whether colleges and universities must retain realized endowment capital gains as principal. *(18)* However, we submit that our review of the history of the development of the law of charitable trusts provides convincing evidence that courts and legal writers have now come to the conclusion that they should.

Moreover, we believe that, if a test case is initiated, it should not be a petition for a declaratory judgment, as proposed by Messrs. Cary and Bright. *(19)*. In this type of legal process, arguments contrary to those of the petitioner are seldom presented with vigor. There is no adverse interest represented. Traditionally, it is the duty of the attorney general of the state to represent the public interest in the administration of charitable or public trusts, *(20)* but, under modern conditions, his more pressing responsibilities give him little time to inform himself on the details of the law of charitable trusts.

The entire thrust of the arguments presented by Messrs. Cary and Bright is that, unless colleges are permitted to expend a portion of their endowment capital gains, they must forego the advantage of investing in the common stock of companies with an attractive long-term growth potential. We do not accept this argument. By adherence to an appropriate diversification program, we believe that any investor who selects sound equities for their growth potential and who is wise enough to develop a rational investment cycle can increase both his principal and his annual income substantially.

The investment committee of a college should recognize the fact that the market price of growth stocks is influenced by a strong demand for them by those in the upper tax brackets. A tax-exempt institution should purchase a growth stock only when it is convinced that its growth potential is sufficiently large to justify paying the premium wealthy investors feel compelled to pay. It should sell it and invest the proceeds in higher income securities just as soon as its increment in market price justifies this action.

Tax Laws Reflect Distinctions

Messrs. Cary and Bright seem to believe that the "only body of learning which treats realized gains as anything other than income is the law of trusts..." *(21)* Have they forgotten the law of taxation? Federal, state and foreign tax legislation gives recognition to the fact that capital gains are quite different from income and tax them, if at all, on a substantially different basis. We believe that colleges and universities will be well advised to continue to maintain this sharp distinction between capital gains and income in their administration of endowments and to rely upon the law of trusts for guidance.

On page 29 of their report, Messrs. Cary and Bright state that "generally accepted accounting principles require net income to include 'all items of profit and loss recognized during the period except for prior period adjustments'." They quote from Accounting Principles Board Opinion No. 9 as authority for this statement. They also quote from paragraph 6 of the Opinion with reference to the application of the principle as follows:

> Investment companies, insurance companies and certain nonprofit organizations have developed income statements with formats different from those of the typical commercial entity described herein, designed to highlight the peculiar nature and sources of their income or operation results. The portion of this Opinion which requires that net income be presented as one amount does not apply to such entities.

They add the following comment:

> Presumably all other portions of the opinion, including the definition of net income, do apply to nonprofit corporations.

We submit that Accounting Principles Board Opinion No. 9 is not relevant to the accounting for income of endowment funds of nonprofit corporations. We know of no member of the American Institute of Certified Public Accountants' committee on accounting procedures or of the Accounting Principles Board in public practice who ever represented that he considered the applicability of such Opinions to nonprofit corporations when assenting to the issuance thereof. On the contrary, each member to whom such inquiry was directed specifically denied that he considered the applicability of the Opinion in question to nonprofit corporations during the period of its drafting.

It seems to us quite clear, therefore, that it is inappropriate to attempt to apply Accounting Principles Board Opinions to nonprofit corporations when those responsible for the drafting and issuance thereof never considered their applicability to nonprofit corporations in the first place. When this same question came up with respect to the applicability of AICPA Accounting Research Bulletins several years ago, the following paragraph was included in the Restatement (paragraph 5 of Accounting Research Bulletin No. 43 issued in 1953):

> The principal objective of the committee has been to narrow areas of difference and inconsistency in accounting practices, and to further the development and recognition of generally accepted accounting principles, through the issuance of opinions and recommendations that would serve as criteria for determining the suitability of accounting practices reflected in financial statements and representations of commercial and industrial companies. In this endeavor, the committee has considered the interpretation and application of such principles as appeared to it to be pertinent to particular accounting problems. The committee has not directed its attention to accounting problems or procedures of religious, charitable, scientific, educational, and similar nonprofit institutions, municipalities, professional firms, and the like. Accordingly, except where there is a specific statement of a different intent by the committee, its opinions and recommendations are directed primarily to business enterprises organized for profit.

CUBA Statement Cites Limitations

In the absence of any official pronouncement by the AICPA Accounting Principles Board with respect to generally accepted accounting principles applicable to nonprofit corporations, it seems to us that we must look to a text published in 1968 by the American Council on Education, *College and University Business Administration*, as the authoritative literature on the subject. The American Institute of Certified Public Accountants designated two of its members to serve as members of the National Committee on all questions of accounting principles. The following is from page 116 of this text:

> Realized gains and losses on investment transactions affect the principal of the invested funds either (1) by increasing or decreasing the individual fund balances or (2) by retaining as an undistributed accumulation the balances that are proportionately applicable to each fund. Such capital gains and losses are not operating revenues and expenditures, and should not be treated differently from the amounts representing the original fund balances. They are subject to the same restrictions and limitations on investment, expenditure, and disposition as the funds from which they arose. *In some instances, realized gains and losses may be attributable to income as a matter of law, for example, when such treatment is required by a specific instrument of gift.*

It is regrettable that The Ford Foundation did not see fit to support the American Council on Education and the work of its National Committee by supporting the concept advocated in the above text, as exemplified by actions taken by the University of Chicago and Cornell University in setting up separate investment pools for endowment funds and funds functioning as endowment. We believe that those who would advocate a change in the generally accepted practices currently in vogue with respect to the accounting for realized gains on endowment funds have the responsibility, or the burden of proof if you will, of effecting such a change in a procedurally sound manner.

During August of 1969 The Ford Foundation published the second report in its "Educational Endowment Series." It is entitled *Managing Educational Endowments*, and the basic document of the report is an essay by Robert R. Barker. His recommendations on pages 45 and 46 of the essay may be summarized as follows:

(1) Trustees should not attempt to manage their endowment portfolios. The decision-making responsibility should be clearly and fully delegated to an able professional portfolio manager with a capable group of fellow professionals around him.

(2) The manager must be free to select his securities for maximum total return.

(3) Each year transfers should be made from endowment to operating funds in an aggregate amount equal to 5 percent of the three-year, moving-average market value of the fund, whether or not that amount is provided by interest and dividends.

The report includes supplementary comments by members of the Advisory Committee on Endowment Management, appointed by The Ford Foundation in 1967. The following are excerpts:

> HOWARD R. BOWEN, *President*, University of Iowa.
>
> I think the report may place too much emphasis on the mystique of the investment manager. I agree that it would be good for colleges and universities to employ sound management and to give this management some leeway. But to find and select the right manager is as hard as it is to select the right stocks in the first place.
>
> I also believe the report should be somewhat less positive in recommending that maximum total return should be the primary objective of a college portfolio. It is possible that the experience of the past several decades was a special situation. It is at least plausible that it was a period of adjustment by the investing public to the peculiarities of an income tax system that discriminates heavily in favor of capital gains and against interest and dividends; that the vast upward movement of equity markets has been part of this adjustment process; and that it may be nearing its culmination.
>
> The report may underemphasize risk. It is true that in the past several decades, many investments considered by some standards to be risky have paid off. It does not follow that under other conditions the same policy would be as rewarding.
>
> J. PARKER HALL, *Treasurer (Retired)*, University of Chicago.
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> The report states that "trustees of most educational institutions, because of semipublic character, have applied a special standard of prudence to endowment management which places primary emphasis on avoiding losses and maximizing present income." In my opinion, this is not an accurate reading of the situation.
>
> The primary objective of endowment investing, it seems to me, has been to support educational activities through the production of income, with long-term growth in value and overall rate of return as secondary considerations. Colleges have preferred to have better teachers, lower tuition, and a cure for cancer today instead of larger endowments ten years hence.

If the courts should rule, as we believe they should and will, that educational and charitable corporations hold their endowments as trustees and not as absolute owners, it will not be possible for them to implement Mr. Barker's recommendations. The courts of equity have declared in unmistakable language that the most important responsibility of a trustee is the selection of securities for the investment of the corpus of his trust and that this responsibility cannot be delegated to others. A trustee may and should seek professional advice, but the final decision must be made by him.

NOTES AND REFERENCES

1. *The Trustees of the Philadelphia Baptist Association v. Hart's Executors*, 17 U.S. 1 (1819).
2. The Statute of Uses, 43 Eliz. 1, c. 4 (1601).
3. Ford W. Hall, "The Common Law: An Account of Its Reception in the United States," 4 *Vand. L. Rev.* 791 (1951).
4. *Vidal v. Girard Executors*, 43 U.S. 127 (1844), see also: 4 *Scott: The Law of Trusts*, Par. 2567-68.
5. 2A *Bogert: The Law of Trusts and Trustees*, Par. 322.
6. *Bascom v. Albertson*, 34 N.Y. 584 (1844).
7. *Conner v. Trinity Reformed Church*, 129 Md. 360; 99 Atl. 547 (1916).
8. *Maxcy v. City of Oshkosh*, 144 Wisc. 238; 128 NW 899; 904. (1910).
9. *Restatement, Trusts*, Par. 349 (1935).
10. 23 *Minn. L. Rev.* 670 (1939).
11. *St. Joseph's Hospital v. Bennett*, 256 App. Div. 120, 8 NYS 2d 922 (1933), reversed, 281 NY 115, 22 NE 2d 305, 311 (1939).

12. For an explanation of the equitable doctrine of cy pres, its early repudiation by the courts of New York and a few other states, and its present acceptance, see *Encyclopaedia Britannica*, Vol. 6, pages 929-30.

13. 130 *ALR* 1101, 1115 (1941).

14. 10 *Colum. L. Rev.* 550, 553 (1940).

15. *Restatement (Second): Trusts.* Par. 348 (1959). For a discussion of the responsibility of the attorney general for the supervision of charitable trusts, see 4 *Scott* 2755 and Bogert, "Proposed Legislation Regarding State Supervision of Charities," 52 Mich. L. Rev. 635, 639, 641 (1954).

16. *American Institute of Architects v. Attorney General*, 332 Mass. 619 127 NE 2d 161 (1955).

17. 4 *Scott* 2567-68.

18. *Page 33 of their report.*

19. *Page 47 ibid.*

20. See Note 15.

21. Page 30 *ibid.*