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The Law and the Lore of Endowment Funds: A 21st Century Edition

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The Law and the Lore of Endowment Funds: A 21st Century Edition

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The title of this presentation has a history. In 1969, the Ford Foundation published a book entitled *The Law and the Lore of Endowment Funds*, by William L. Cary and Craig B. Bright.[1] This slender volume offered a broad survey of the state of the law (and the lore) concerning the investment and expenditure of endowment funds and concluded that there was "no authoritative support *in the law* for the widely held view that the realized gains of endowment funds can never be spent" (emphasis added). The authors went on to say:

> Prudence would call for the retention of sufficient gains to maintain purchasing power in the face of inflation and to guard against potential losses, but subject to the standards which prudence dictates, the expenditure of gains should lie within the discretion of the institution's directors.[2]

This conclusion may not have been as much of a jolt to American life as some of the other notable events of 1969 – *e.g.*, the U.S. release of the first Led Zeppelin album, Woodstock, Neil Armstrong setting foot on the moon, or the premier of *Sesame Street.* But it was a jolt nonetheless. After *Law and Lore*, boards populated by "prudent men" (as the law then denominated them) seemed to feel that they, too, could partake of the liberation *Zeitgeist*. At last being told that they were untethered from ancient trust law and its rigid distinction between income (interest, dividends, rent, etc.) and principal (the original corpus and the capital gain earned thereon), boards began moving swiftly to embrace "total return."

In a sequel about five years later[3], the authors of *Law and Lore* reported that Dartmouth, Princeton, Smith and the Smithsonian had followed the lead of Cornell, Yale and the University of Chicago by adopting "some form of the total return concept" for their endowment investing and spending. In addition, they reported that a 1971 survey by Louis Harris and Associates, Inc., of 660 nonprofit institutions with endowments valued at $5,000,000 or more had shown that 54% of them "approved the total return concept" and that 71% of colleges and universities in the survey approved the concept.[4] Furthermore, the National Association of College and University Business Officers (NACUBO) had begun to advocate for modification of accounting practices to accommodate the total return concept,[5] and the Ford Foundation had fostered the establishment of The Common Fund as a vehicle for pooled investing that allowed "total return investing" by professional managers with delegated

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1 Cary taught law at Columbia, and both authors were lawyers at Patterson Belknap & Webb, as the firm was then known.

2 Cary and Bright, *The Law and the Lore of Endowment Funds* (1969) 66.

3 Cary and Bright, *The Developing Law of Endowment Funds: "The Law and the Lore" Revisited* (1974).

4 *Id.* at 9.

5 *Id.* at 10.

authority to make investment decisions.[6] Perhaps most importantly, the National Conference of Commissioners on Uniform State Laws had promulgated the Uniform Management of Institutional Funds Act (UMIFA) and recommended it be adopted nationally. In those states where it would be adopted, UMIFA not only expressly authorized the prudent appropriation of realized appreciation on endowment funds; it offered a rule of construction that would enable the governing instruments of old endowment funds to be interpreted so as to (in effect) disregard seemingly strict language authorizing only the expenditure of "income."[7] UMIFA was almost universally adopted (specifically, in 1978 by New York and in 1989 by Texas).

Modern as it was, UMIFA nonetheless preserved the concept of "historic dollar value" – the so-called "waterline" as it is referred to among the keepers of the lore of endowment funds. It took another uniform act, the Uniform *Prudent* Management of Institutional Funds Act (UPMIFA) (2006) to support the outright elimination of the waterline. Slowly but surely, UPMIFA supplanted UMIFA (2007 in Texas, 2010 in New York), and today UPMIFA is (with minor state-specific variations) the law in 49 states. Even Pennsylvania, the lone UPMIFA holdout, has a statute that authorizes percentage-based spending from endowment funds, thereby permitting institutions to dip below the waterline in their spending. *See* 15 Pa. C.S.A. §5548(c).

In 2020, more than a half century since the publication of *Law and Lore*, and despite all of the endowment-law codification that was incorporated into UMIFA and UPMIFA, it is striking how much of endowment law is still a matter of tradition and practice passed from generation to generation in a particular institution. The term "waterline" has its metaphoric cognate – a fund below the waterline is said to be "underwater" – but other terms can also be found. The terms "deficiency" and "deficit" are common, especially in audited financial statements, and in casual contexts, more than a few organizations refer to underwater funds as "being upside down" or "going upside down." Even though UPMIFA speaks of an "appropriation" from an endowment fund, almost no one uses that term in ordinary parlance. The term "draw" is probably the most common, along with "draw rate" to describe the percentage. Yet one also hears "spend rate" or "spending rate," and at least one major organization refers to its endowment appropriation as the "spin-off." Whether the "draw" is calculated in advance, periodically throughout the year, or subject to adjustment at the end of the year – all of these issues and more are matters that vary from place to place. Institutions can be surprisingly imprecise about the use of the term "endowment," leading to confusion about whether a spreadsheet, a PowerPoint presentation, or even the name assigned to a brokerage account is meant to refer to true endowment (donor-restricted) or quasi-endowment (board-restricted) or both.

Ideally, institutions have maintained consistent, accurate records concerning the historic dollar value of endowment funds and are able to track whether a given fund has been able to

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6 *Id.* at 11.

7 *Id.* at 12.

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