

Risk, Return and Social Impact: Demystifying the Law of Mission Investing by U.S. Foundations

October 2008

Anne Stetson & Mark Kramer

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Table of Contents

Executive Summary	4
Introduction	10
Part I: Legal Restrictions on Mission Investing by U.S. Foundations	16
A. Federal Tax Laws	17
1. Introduction	17
2. Jeopardy Investments	19
3. Program-Related Investments	23
a. Introduction	
b. Guidance Provided Under Regulations	
c. Guidance Provided Under Rulings	
4. Mission Investments That Do Not Qualify as Program-Related Investments	33
5. Summary	34
B. State Fiduciary Laws	35
1. Introduction	35
2. Uniform Prudent Management of Institutional Funds Act	37
a. Standard of Prudence	
b. Endowment Spending and Preservation	
3. Uniform Management of Institutional Funds Act	41
4. Uniform Prudent Investor Act	42
Part II: Foundation Mission Investing In Practice	46
A. Fiduciary Responsibility Redefined	47
B. Emerging Practices in Philanthropy: Social Entrepreneurship	54
Part III: Recommendations	56
A. Legal Clarification	57
1. Federal Tax Law	57
2. State Law	59
B. Foundation Investment Practices and Policies	60
Part IV: Conclusion	63

Appendix A: Examples of Jeopardizing and Non-Jeopardizing Investments	65
Appendix B: Approved Program-Related Investments by Asset Class	69
Appendix C: Program-Related Investment Examples Under U.S. Treasury Regulations	74
Appendix D: Proposed Program-Related Investment Examples Submitted by the American Bar Association	80
Appendix E: Case Study: California	102
Appendix F: Case Study: New York	109
Appendix G: Case Study: Oregon	115
Appendix H: Sample Investment Policy Statement	119
Bibliography	126

Executive Summary

Foundations increasingly seek to make investments in alignment with their charitable missions. Such “mission investments” have grown at an annualized rate of more than sixteen percent over the last five years.¹ Confusion remains, however, about the extent to which the relevant laws permit directors or trustees of a foundation to consider mission-related factors, in addition to risk and financial return, when making investment decisions. This paper analyzes the legal considerations applicable to private and community foundations under federal and state laws. We conclude that foundations have considerable latitude to make investments that further their charitable missions, even if this results in greater risk or lower financial returns.²

Broadly speaking, foundations that wish to use their investments to further charitable objectives can do so in three ways, which together we refer to as “mission investing”:

- **Screening:** Foundations can impose positive as well as negative screens on their investment portfolios to screen in or out securities in alignment with the charitable mission of the foundation.
- **Proactive Investments:** Foundations can also make specific mission-related investments (“MRI”) or program-related investments (“PRI”) in nonprofit or for-profit organizations that advance the charitable missions of the investing foundation.
- **Shareholder Advocacy and Proxy Voting:** Foundations can use their investments as a means to engage in shareholder advocacy through dialogue with corporate management, shareholder resolutions, and proxy voting to influence a corporation’s behavior on issues relevant to the foundation’s mission.

In each case, the consideration of mission-related factors, or the added expenses of screening and shareholder advocacy, may reduce the foundation’s financial returns below those it might have earned had it ignored such criteria in its investment decisions. The question arises, therefore, whether the law permits the foundation to accept lower financial returns out of deference to its mission.

When making investment decisions, whether about conventional investments or the mission investments described above, foundation trustees and directors must consider the donor’s intent, as well as federal tax laws and state fiduciary laws.³ These laws independently and as a whole allow

¹ SARAH COOCH & MARK KRAMER, FSG SOCIAL IMPACT ADVISORS, *COMPOUNDING IMPACT: MISSION INVESTING BY U.S. FOUNDATIONS* (2007), available at: http://www.fsg-impact.org/app/content/ideas/item/Compounding_Impact.html.

² Each foundation should consult its own legal counsel and should not rely on this memo as legal authority about any specific transaction.

³ Foundations are generally subject to the laws of the state where the corporation or trust was established. If the foundation has principal offices or substantial activities in a different state, that state’s laws may also apply.

broad discretion in the management of foundation assets. The law does not require a foundation director or trustee to achieve the *maximum* risk-adjusted return on foundation investments without regard to social considerations that might advance the foundation's mission, even in a case in which the permanent existence of the foundation is protected as an endowment. Rather, the law requires a fiduciary to invest to ensure the capacity of the foundation to fulfill its charitable purposes in the short and long term. So long as prudence is exercised and due care is taken in making investment decisions, the social impact of an investment on a foundation's charitable purpose may be weighed by a fiduciary.

Donor Intent

State laws of fiduciary duty give primacy to donor intent over other considerations, while the relevant federal tax law refers to fulfillment of the foundation's charitable purposes. Therefore, if a donor has indicated in writing that mission related factors may be considered in investment decisions, or that the foundation's assets need not be preserved as a long-term endowment, neither the Internal Revenue Code ("I.R.C.") nor state law will limit the ability of trustees or directors to make investments for mission-related objectives, even at a sacrifice of financial return or increase in risk.⁴ Note, however, that language related to mission investing is still rare in most foundation documents; in many states the donor will be presumed to have intended to create a permanent endowment unless it was explicitly stated otherwise. In such cases, the law requires that the assets be managed to ensure the foundation's perpetual existence, and a sacrifice of financial performance in favor of charitable mission may be made only with consideration for the whole portfolio.

⁴ The provisions of the I.R.C. that might limit a mission investment made with a donor's blessing include:

- If the investment is deemed to be so risky as to jeopardize the capacity of the foundation to fulfill its charitable purposes in the long- or short-term. I.R.C. § 4944.
- If the investment constitutes "excess holdings" by controlling more than twenty percent of the voting stock of a company (qualifying program-related investments excepted). I.R.C. § 4943.
- If the investment generates unrelated business income tax because it is unrelated to the foundation's mission. I.R.C. § 511.
- If the investment funds lobbying activities. I.R.C. § 170(c)(2)(D).
- If the investment constitutes self-dealing by conferring an economic benefit on the donor, trustees, directors, or other "disqualified persons" as defined by I.R.C. § 4941.

Relevant Federal Tax Law

Federal tax laws clearly permit mission investing by U.S. foundations. Certain federal tax restrictions, such as prohibitions on self-dealing and lobbying, apply to all private foundation activities, including investments. In addition, the law prohibits a private foundation from making an investment that jeopardizes a foundation's ability in both the short and long term to fulfill its charitable purposes (a "jeopardy investment").⁵ The regulations interpreting this prohibition track the prudent investor standard, which explicitly takes into account the charitable purposes of the foundation. A mission investment by definition seeks to advance the charitable purposes of a foundation, but of course, must be considered within the total portfolio of the foundation. An exception to the jeopardy investment prohibition permits "program-related investments" ("PRIs") which must be made primarily to advance the charitable purposes of the foundation, and may not be made with profit as a significant motive in the investment decision.⁶ Although foundations often interpret this to require that PRIs earn little or no financial return, I.R.S. private letter rulings make clear that even market rate returns may be permissible as long as there is at least one term of the investment that a profit-seeking investor would not have accepted.

Community foundations, by contrast, are not subject to the federal tax prohibitions against self-dealing, excess business holdings, or jeopardy investments. (They are, of course, subject to the federal law prohibitions applicable to charitable institutions, such as the restriction on private inurement and excess benefits.) As a result, the analysis of federal tax law relevant to mission investing focuses on the rules applicable to private foundations, and not to community foundations. State fiduciary laws, however, apply to private and community foundations alike.

⁵ I.R.C. § 4944.

⁶ I.R.C. § 4944(c).

State Fiduciary Laws

With respect to state fiduciary law, the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”)⁷, which supersedes the Uniform Management of Institutional Funds Act (“UMIFA”)⁸, adopts the prudent investor rule for nonprofit corporations that the Uniform Prudent Investors Act (“UPIA”)⁹ applies to trusts.¹⁰ This rule allows a fiduciary to consider the charitable purposes of the institution in managing its assets.¹¹

If a foundation’s assets were donated with the intention of establishing a permanent endowment, then UPMIFA requires that those assets be managed to maintain the value of the assets over time, while generating adequate investment returns to meet annual payout requirements. By contrast, the older uniform act, UMIFA, requires only that the historic dollar value of the assets be preserved, while generating adequate income for minimum payout requirements. UPIA imposes a prudent investor standard on trusts and prohibits investment in “socially responsible investments” if they involve a sacrifice of performance such that the interests of the trust’s beneficiaries are compromised (a duty of loyalty standard). These interests have been correctly interpreted as purely financial in nature when applied to a private trust for the benefit of individuals. However, in the case of a charitable trust, a sacrifice of financial performance in furtherance of the charitable purposes of the foundation should not give rise to a conflict between the trust’s beneficiaries (those benefiting from its charitable work) and the mission investment. As a result, investments that further the charitable interests of a charitable trust do not *per se* violate the duty of loyalty and are permissible under state fiduciary laws.

Our analysis concludes that these uniform laws do not require a fiduciary to maximize financial performance, even if the foundation’s assets constitute a permanent “endowment” as legally defined (although in this case, care must be taken to manage the assets in such a way as to ensure that the assets of the foundation are not eroded over time). As a result, a foundation may invest to advance its mission even if this strategy results in inferior investment returns. The latitude that fiduciaries often assume they possess to spend down a foundation’s assets in advancement of its charitable purposes can be legally supported, unless the foundation is deemed an endowment.

⁷ Uniform Prudent Management of Institutional Funds Act (“UPMIFA”)(2006). For the full text of UPMIFA, see http://www.law.upenn.edu/bll/archives/ulc/umoifa/2006annualmeeting_approvedtext.htm.

⁸ Uniform Management of Institutional Funds Act (“UMIFA”)(1972). For the full text of UMIFA, see <http://www.law.upenn.edu/bll/archives/ulc/fnact99/1970s/umifa72.pdf>.

⁹ Uniform Prudent Investor Act (“UPIA”)(1994). For the full text of UPIA, see <http://www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upia94.pdf>.

¹⁰ UPIA § 2(a).

¹¹ UPMIFA § 3(a).

Conclusion

If a foundation engages in a careful investment process to make investments that do not aim purely to maximize returns, but to optimize returns while serving the social mission of the foundation, a violation of the jeopardy investment rule or the relevant uniform statute is unlikely to occur. More specifically, mission-related investments that are reasonably expected to produce market rate investment returns, or at least returns at above inflation plus payout, are permissible under the law. And mission investments that are below market rate are permissible so long as either (1) their financial impact on the overall portfolio is expected to be mitigated by higher performing investments, such that the long-term value of foundation assets is not compromised, or (2) that investment qualifies as a PRI. If a foundation’s assets are managed to accommodate both payout and inflation year to year, and perform no better or worse than to meet these objectives, we conclude that the requirements of federal tax law and the relevant state laws will be met.

It is important to point out that an inherent trade-off between financial and social returns can no longer be assumed, thanks to the development of investment opportunities that deliver market-rate financial returns while incorporating pro-active environmental, social, or governance screens.¹² In fact, considerable evidence has accumulated that taking environmental and social considerations into account may actually increase investment returns.¹³ Equally important, mission-related investment strategies are increasingly available that deliver market rates of return, as benchmarked against their respective asset classes.¹⁴ But even in the case of such a trade-off, we conclude that in the case of foundation assets, some sacrifice of financial performance in favor of social impact is permissible under the law, so long as due care is exercised throughout the investment process.¹⁵

¹² This trade-off has historically been the most often voiced objection to the “prudence” of mission investing. See generally John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72 (1980).

¹³ See generally ABBY JOSEPH COHEN & MICHAEL MORAN, THE GOLDMAN SACHS GROUP, INC., PORTFOLIO STRATEGY UNITED STATES (2006), available at: <http://www2.goldmansachs.com/ideas/environment-and-energy/port-strat-growing-interest-pdf.pdf>; U.N. ENV’T PROGRAMME FINANCE INITIATIVE WORKING GROUP, SHOW ME THE MONEY: LINKING ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES TO COMPANY VALUE (2006).

¹⁴ See, e.g., FB. HERON FOUND., NEW FRONTIERS IN MISSION-RELATED INVESTING (2003), available at: http://www.fheron.org/documents/ar.2003.viewbook_new_frontiers.pdf; INST. FOR RESPONSIBLE INVESTMENT, BOSTON COLLEGE CENTER FOR CORPORATE CITIZENSHIP, HANDBOOK ON RESPONSIBLE INVESTMENT ACROSS ASSET CLASSES (2007).

¹⁵ This interpretation does not apply to the investment of the corpus of a personal trust or to the investment of pension plans.

Introduction

The growing interest among U.S. foundations in mission investing — the practice of using a foundation’s investments to further or align with its charitable purposes — has prompted greater attention to the complexities a foundation must navigate in considering and implementing a mission-investing program. Several helpful reports have been produced recently that provide guidance to foundation staff and trustees seeking to determine whether, and how, to engage in mission investing.¹⁶ This report seeks to fill a gap in the growing literature by clarifying the legal parameters surrounding the investment of a foundation’s assets in accordance with the charitable mission of the foundation.

In our past research on mission investing¹⁷ and through our own experience in advising foundations, we have discovered an array of opinions concerning whether tax and fiduciary laws permit, prohibit or are neutral about mission investing. Ambiguities in the relevant laws trigger confusion and the need for clarification. This report provides a tool to foundation staff, trustees and their counsel to navigate the law relevant to mission investing by setting out clearly the substance of relevant laws and regulations, how they have been interpreted by legal authorities and practitioners, and how a foundation might best address the legal complexities of mission investing.

How do we define “mission investing”?

Broadly speaking, foundations that wish to use their investments to further charitable objectives can do so in three ways, which together we refer to as “mission investing:”

- **Screening:** Foundations can screen their investment portfolios to invest in companies the activities of which advance the charitable mission of the foundation (such as investment in alternative energy companies by a foundation focused on protecting the environment). Foundations may also impose negative screens to avoid investing in companies engaged in activities that may conflict with their missions (such as investment in tobacco companies by a foundation focused on improving health outcomes).
- **Proactive Investments:** Foundations can also make specific investments in nonprofit or for-profit organizations that provide mission-related products and services, such as making loans to their grantees, investments in affordable housing, or the development of therapeutic drugs. These investments, sometimes referred to as “mission-related investments,” may offer either below-market or market-rate financial returns. In the case of private foundations, many of these investments may qualify as “program-related investments” under federal tax law (discussed below in more detail).
- **Shareholder Advocacy and Proxy Voting:** Foundations can use their investments as a means to engage in shareholder advocacy through dialogue with corporate management, shareholder resolutions, and proxy voting to influence a corporation’s behavior on issues relevant to the foundation’s mission.

¹⁶ See, e.g., INST. FOR RESPONSIBLE INVESTMENT, *supra* note 14; STEVEN GODEKE & DOUG BAUER, ROCKEFELLER PHILANTHROPY ADVISORS, PHILANTHROPY’S NEW PASSING GEAR: MISSION-RELATED INVESTING: A POLICY AND IMPLEMENTATION GUIDE FOR FOUNDATION TRUSTEES (2008), available at <http://rockpa.org/wp-content/uploads/2008/01/MRI.pdf>; KYLE JOHNSON, CAMBRIDGE ASSOCIATES, SOCIAL INVESTING (2007).

¹⁷ SARAH COOCH & MARK KRAMER, *supra* note 1; MARK KRAMER & SARAH COOCH, FSG SOCIAL IMPACT ADVISORS, AGGREGATING IMPACT: A FUNDER’S GUIDE TO MISSION INVESTMENT INTERMEDIARIES (2007), available at <http://www.fsg-impact.org/app/content/ideas/item/545>.

Many foundation boards make investment decisions with a single objective in mind: to maximize financial returns within prudent levels of risk. This is assumed to be consistent with the intent of the donor, and both federal tax laws and various state laws include provisions to require the foundation board to ensure that a foundation will be able to fulfill its charitable purposes on a permanent basis. When making mission investments, however, the foundation board adds a third consideration to the traditional risk and return analysis by weighing any number of environmental, social, or governance (“ESG”) factors that go beyond the traditional investment analysis. If these additional constraints lead to sub-optimal investment returns, then they may conflict with the expectation of maximizing returns and raise the question as to whether they are prudent and therefore within the fiduciary duties imposed on foundation boards by the law.

Notably, the question of whether taking ESG factors into account lowers financial returns is increasingly subject to debate. One traditional school of thought suggests that any consideration of non-financial factors or any narrowing of the universe of potential investments through screening necessarily results in sub-optimal returns. On the other hand, Goldman Sachs, Innovest, and a number of investment funds have demonstrated in recent years that portfolios composed of companies that perform best on ESG measures tend to outperform world market indices.¹⁸ Depending on the way in which a foundation employs mission investments, we find numerous examples of investments that perform at or above market rate and many others that perform below market rate. We therefore consider the legal issues from both perspectives, without attempting to resolve the economic debate.

As defined in both federal and state laws, the modern prudent investor rule governs fiduciary responsibility with respect to the management of a foundation’s investment assets. This rule calls upon the fiduciary to invest in accordance with modern portfolio theory, which requires the diversification of assets, and consideration for the impact of a single security on the overall portfolio.¹⁹ As a result, single investment selections – including mission investments – should not be evaluated based on their individual risk/return characteristics, but in the context of the portfolio’s overall risk/return characteristics. The modern prudent investor rule also prohibits an evaluation of prudence based on hindsight; the prudence of an investment decision must be determined based on the facts available at the time the investment was made. The rule imposes a duty of loyalty upon the prudent investor, which is consistent with the business judgment rule that we find in state corporations laws, and in the Uniform Management of Institutional Funds Act (“UMIFA”).²⁰ Stated simply, the business judgment rule holds that a court will not second-guess a business decision – including an investment decision – so long as it is made with due care and loyalty in the exercise of “business judgment.” In practice, as discussed below, no cases or state attorneys general opinions consider investment decisions by foundation fiduciaries, except in the case of self-dealing or flagrant negligence.

¹⁸ See, e.g., GOLDMAN SACHS, GS SUSTAIN (2007) (documenting that companies with better performance on environmental, social and governance criteria outperformed the world market index), available at http://www.unglobalcompact.org/docs/summit2007/gs_esg_embargoed_until030707.pdf; Generation Investment Management, an investment fund established by Al Gore and former Goldman Sachs investor David Blood that aims to provide superior long term returns through including an analysis of sustainability practices in the investment process, <http://www.generationim.com>; F.B. Heron Foundation, which invests roughly one-quarter of its assets in a diverse portfolio of mission investments and tracks their performance against conventional benchmarks for each asset class, <http://www.fbheron.org>.

¹⁹ Developed by Harry Markowitz, and published in his seminal article, *Portfolio Selection*, in the Journal of Finance in 1952, “modern portfolio theory” is one of the most influential economic theories relevant to finance and investment. The theory espouses the diversification of portfolio assets as a means of reducing risk. The expected risk and return of any one stock is irrelevant to the theory. Rather, the riskiness of the portfolio as a whole must be assessed. For a seminal study of the prudent man rule and a call for its modernization, see BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE (1986).

²⁰ See *infra* Part I.B.1.

What laws and regulations determine the legality of “mission investing”?

The investment activities of private foundations are regulated both by federal tax law, and by state fiduciary law. Community foundations, by contrast, are not defined by the federal tax code as “private foundations,” but as public charities. While both types of vehicles are subject to the tax rules flowing from qualification as a charitable organization under I.R.C. 501(c)(3), the I.R.C. applies strict prohibitions on investment holdings only to private foundations. However, in general, the same fiduciary standards of care, loyalty, and prudent investment applicable to private foundations will apply to community foundations.

Part I of this report considers the legality of mission investing under the I.R.C.’s restrictions on private foundation investment activity, and state fiduciary law. Specifically, I.R.C. 4944(a) levies a tax on investments that are deemed by the Internal Revenue Service (“I.R.S.”) to subject the foundation to undue risk. I.R.C. 4944(c) provides an exception to that by explicitly permitting “program-related investments” that aim primarily to advance the charitable purposes of the foundation, so long as the production of income or appreciation of property is not a significant purpose and lobbying is not supported by the investment. Our analysis focuses on these laws, and related regulations and guidance issued by the I.R.S.

Determining the legality of mission investing under state law requires a close look at three uniform acts that have been adopted by many states, as well as an analysis of the general fiduciary duties underlying state nonprofit corporation and trust laws. The prudent investor rule, the duties of care and loyalty, and the business judgment rule provide the framework for the relevant state laws.

The three uniform acts that this section of the report considers are:

- The Uniform Prudent Management of Institutional Funds Act (UPMIFA)
- The Uniform Management of Institutional Funds Act (UMIFA), which UPMIFA repeals and replaces; and
- The Uniform Prudent Investor Act (UPIA).

In order to illustrate how these laws interplay, we have considered the fiduciary duties owed to private foundations under the state laws of two jurisdictions in which many U.S. foundations operate — California and New York — and the state laws of Oregon, in which the practice of mission investing is quickly developing. These case studies appear in the Appendices at E through G.

Having considered the legality of mission investing under federal tax and relevant state laws, we turn in Part II to consider how foundations engage in mission investing in practice. In Part III, we identify areas of the law in which clarification would simplify the legal analysis necessary before engaging in a mission investment, and thereby enhance the potential impact of the philanthropic field, and provide recommendations to foundations that wish to engage in mission investing squarely within the requirements of the law. And lastly, in Part IV, we conclude with a brief summary of our findings.

Our goal in producing this report is modest in focusing on the bridge between foundation investments and grantmaking objectives. We aim to clear a path for foundations confounded by perceived legal restraints on mission investing, so that they will be empowered to explore investing consistently with their charitable missions, and thereby use the full range of their resources to achieve greater social impact. By engaging in mission investing side by side with effective grantmaking, we hope that not only will individual foundations amplify their capacity to advance their missions, but the social problems they seek to resolve may be addressed more effectively. Many of these problems are urgent and dire — climate change, poverty alleviation, and global health are just a few such examples — and demand that foundations leverage every resource available.

Part I:

Legal Restrictions on Mission Investing by U.S. Foundations

A. FEDERAL TAX LAWS

1. Introduction

Every charitable vehicle in the United States defined under federal tax law as a private foundation is governed by a small set of regulations under the U.S. Internal Revenue Code (“I.R.C.”), regardless of the state in which it is established, and regardless of its legal character as a trust or nonprofit corporation. The relevant law was promulgated under the Tax Reform Act of 1969, which aimed to curb abuses perceived as violative of the tax exemption granted to private foundations.²¹

Our analysis of the legality of mission investing under the federal tax regulations focuses on I.R.C. § 4944, which prohibits investments that “jeopardize the carrying out” of any of a foundation’s exempt purposes.²² “Jeopardy” investments have been interpreted under the Tax Reform Act’s legislative history and the examples issued under the regulation interpreting I.R.C. § 4944(a) as those that are unduly risky, and therefore subject the foundation to unreasonable risk of loss. The section also carves out an exception to the jeopardy investment rule, termed program-related investments (PRIs).²³ An investment will qualify as a PRI and will thereby not trigger the jeopardizing investment tax, even if it is highly risky, so long as its primary purpose is to accomplish one or more of the foundation’s charitable purposes, and no significant purpose is the production of income or the appreciation of property.²⁴ (A thorough discussion of PRIs occurs below at I.A.3.) An additional exception to the prohibition carves out investments received as gifts to the foundation.

²¹ For an excellent account of the legislative history and an analysis of the Tax Reform Act of 1969, and the regulations under it applicable to private foundations, see Richard Schmalbeck, *Reconsidering Private Foundation Investment Limitations*, 58 TAX L. REV. 59 (2004).

²² I.R.C. § 4944.

²³ I.R.C. § 4944(c).

²⁴ Treas. Reg. § 53.4944-3(a)(1).

Under § 4944, the I.R.C. imposes an excise tax on jeopardy investments. Notably, the I.R.S.'s sanctions on jeopardy investments merely impose a tax, and do not extend to the withdrawal of the foundation's tax-exempt status, unless a private foundation willfully and repeatedly or flagrantly violates I.R.C. § 4944.²⁵ Our research disclosed no case in which the I.R.S. has withdrawn a foundation's tax-exempt status under this section.

While § 4944 is the most relevant section of the I.R.C. for the purposes of this report, it is not the sole section relevant to private foundations. I.R.C. §§ 4940 through 4946 include prohibitions against self-dealing²⁶ and excess business holdings, among other prohibited activity. In general, the excess business holdings rules of I.R.C. § 4943 limit the extent of a private foundation's investment in a business entity to twenty percent of the voting or ownership interest in the entity.²⁷ The Tax Reform Act of 1969 imposed this limit out of a concern that a foundation holding a controlling interest in a business would be distracted from furthering its charitable mission, and might obtain an unfair advantage over businesses that pay taxes on income derived from businesses. Notably, investments that qualify as program-related investments are not subject to the excess business holdings rule.²⁸ The "Unrelated Business Income Tax" (UBIT) derives from another provision of the I.R.C. relevant to private foundations. UBIT imposes a tax on income derived from commercial activity not substantially related to the exempt purposes of a charitable organization.²⁹ We do not examine sections of the I.R.C. beyond § 4944; however, we note that all foundation investments – including mission investments – are subject to these restrictions.³⁰

When applying § 4944, investments can fall into one of three categories:

- Jeopardizing investments
- Program-related investments
- Investments that are neither jeopardizing nor program-related.

We consider each in turn.

²⁵ I.R.C. § 507(a)(2).

²⁶ I.R.C. § 4941.

²⁷ I.R.C. § 4943. For a succinct summary of the federal tax regulations applicable to private foundations, see BETSY ADLER, INGRID MITTERMAIER & DAVID LEVITT, *THE RULES OF THE ROAD: A GUIDE TO THE LAW OF CHARITIES IN THE UNITED STATES* Chapter 4 (2007).

²⁸ Treas. Reg. § 53.4943-10(b).

²⁹ I.R.C. § 511.

³⁰ But note again that a qualifying program-related investment is not subject to the excess business holdings rules of I.R.C. § 4943. See *supra* note 28.

2. Jeopardy Investments

What elements of an investment are relevant to a determination that it may jeopardize a foundation's capacity to fulfill its exempt purposes? The Treasury regulation issued under this section of the I.R.C. incorporates principles of the prudent investor standard that also undergirds state fiduciary laws in setting out the following determinants, while not invoking the term "prudent investor":

- The foundation managers, in making the investment, failed to exercise ordinary business care and prudence;
- The standard of care and prudence applied by foundation managers failed to take due consideration of risk, return, and portfolio diversification;
- Due consideration for the facts and circumstances prevailing at the time of making the investment is relevant, and not how those facts and circumstances appear with the wisdom of hindsight;
- The investment under scrutiny will be considered individually, within the context of the foundation's overall portfolio;
- The investment jeopardizes the long-term and short-term financial needs of the foundation.³¹

³¹ Treas. Reg. § 53.4944-1(a)(2)(i) provides: Except as provided in § 4944(c), 53.4944-3, 53.4944-6(a), and subdivision (ii) of this subparagraph, an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return). The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole. No category of investments shall be treated as a *per se* violation of § 4944. However, the following are examples of types or methods of investment which will be closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence: Trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of "puts," "calls," and "straddles," the purchase of warrants, and selling short. The determination whether the investment of any amount jeopardizes the carrying out of a foundation's exempt purposes is to be made as of the time that the foundation makes the investment and not subsequently on the basis of hindsight. Therefore, once it has been ascertained that an investment does not jeopardize the carrying out of a foundation's exempt purposes, the investment shall never be considered to jeopardize the carrying out of such purposes, even though, as a result of such investment, the foundation subsequently realizes a loss.

The regulation notes that no category of investments will be treated as *per se* jeopardizing, but then proceeds to set out a list of types of investment activity that may trigger scrutiny.³² One interesting aspect of these suspect activities is that the I.R.S.'s view of speculative activity has indeed evolved, although that evolution has progressed slowly and generally well behind market practice. Current guidance issued by the I.R.S. to its staff in 1998 lists the following strategies as deserving of close scrutiny: equity investments in "third world countries;" investments in hedge funds; junk bonds, derivatives, risk arbitrage, and distressed debt.³³ Many of these asset classes are now considered by leading investment managers and consultants to constitute integral components of a prudently diversified investment portfolio.

The broad-brush examples provided under the regulation illustrate the importance of exercising care and prudence in making investment decisions.³⁴ Where consideration for an investment's earnings record, capitalization, and risk/return profile informs an investment decision, no jeopardizing character will likely be imputed to it by the I.R.S. Portfolio diversification and provision for a foundation's short- and long-term financial needs also weigh in favor of a finding that an investment does not violate the prohibition.³⁵ The I.R.S. has stopped short of enunciating a bright-line definition of what percentage of a foundation's assets invested in any one security or investment strategy will be deemed "jeopardizing"; as a result, we do not have clear guidance on diversification requirements.

³² *Id.* These include trading in margin securities or commodity futures; investing in working interests in oil and gas wells; purchasing puts, calls, straddles, or warrants; and short-selling. *But see infra* notes 43-47 and accompanying text for a discussion of private letter rulings determining that certain of these vehicles are not *per se* jeopardizing.

³³ INTERNAL REVENUE SERVICE, PRIVATE FOUNDATIONS HANDBOOK, § 7.27.18.2.3 (1998) (discussing Close Scrutiny of Certain Investments), *available at* <http://www.irs.gov/irm/part7/ch12s15.html#d0e117979>. The I.R.S. issues staff manuals to provide instructions in interpreting the law and regulations under the I.R.C.

³⁴ For the full text of the examples, see *infra* Appendix A.

³⁵ By contrast, a lack of diversification may lead in part to a finding that an investment is jeopardizing. See I.R.S. Tech. Adv. Mem. 92-05-001 (Jan. 31, 1992).

The law and the regulations issued under it have historically been interpreted as requiring consideration only for the financial impact of an investment on a foundation's capacity to fulfill its charitable purposes. But if we expand the boundaries of the jeopardy investment rule to consider social impact, we quickly arrive at the observation that by definition, a mission investment is made precisely to fulfill those purposes. How then can it jeopardize the foundation's ability to accomplish what the investment by definition achieves? The law as it has been interpreted does not integrate a concern for financial sustainability with an imperative on fulfilling charitable purposes in any but the narrowest sense.

The resulting confusion as to what constitutes a jeopardy investment has generated, over the almost forty years in which it has been in place, a proliferation of legal analysis. Yet almost all of the guidance issued under the rule focuses on whether an investment will qualify for the program-related exception to the rule. Few cases address a substantive violation of the rule.³⁶ The private letter rulings (PLRs)³⁷ interpreting the rule number over a thousand, yet most address procedural questions, or exemption as a "program-related investment."³⁸ Very few grapple with the definition of a "jeopardy investment." Revenue rulings³⁹ and technical advice memoranda (TAM)⁴⁰ also provide only limited guidance. The following summary gleans the available guidance from those PLRs and TAM that determined a jeopardizing investment was at issue:

- Investments in unsecured loans were found to be jeopardizing (1981)⁴¹
- Investment in asset collateralizations were found to be jeopardizing (1986)⁴²

³⁶ *But see* Janpol v. Comm'r, 101 T.C. 518 (1993) (holding that guarantees or collateralizations are a type of money lending or an extension of credit and, thus, are forms of investment activity and deserve close scrutiny); Thorne v. Comm'r, 99 T.C. 67 (1992) (holding that the investment of the entire corpus of a foundation in a foreign bank without inquiring into the integrity of the bank was a jeopardizing investment).

³⁷ A private letter ruling is a written statement issued by the I.R.S. in response to a request from a taxpayer that interprets and applies tax laws to the taxpayer's specific set of facts. It is binding on the taxpayer, but may not be relied on as precedent by other taxpayers or I.R.S. personnel.

³⁸ See analysis of private letter rulings and revenue rulings under § 4944(c) *infra* at Part I.A.3.c.

³⁹ A revenue ruling is an official interpretation by the I.R.S. of the I.R.C. and regulations issued under it, and may be relied upon as precedent.

⁴⁰ A technical advice memorandum consists of guidance furnished by the I.R.S.'s Office of Chief Counsel upon the request of an I.R.S. director or area director in response to technical or procedural questions that develop during a proceeding, such as an examination of a taxpayer's return. Technical advice memoranda provide the I.R.S.' interpretation of proper application of tax laws, regulations, revenue rulings, or other precedents.

⁴¹ See I.R.S. Tech. Adv. Mem. 82-06-036 (1982).

⁴² See I.R.S. Tech. Adv. Mem. 96-27-001 (July 5, 1996).

By contrast, PLRs have determined that the following investments would not be considered to be jeopardizing:

- Small cap stocks (1997)⁴³
- Venture capital funds (1997)⁴⁴
- Distressed securities (1997)⁴⁵
- Oil and gas interests (1994)⁴⁶
- Commodities contracts (1992)⁴⁷

An emphasis on the exercise of due care and prudence in making an investment recurs in the limited rulings on jeopardy investments.

If the I.R.S. determines that a foundation has made a jeopardizing investment, the I.R.C. imposes a tiered tax on the foundation⁴⁸ and potentially on the foundation managers, if they knew the investment at issue would constitute a jeopardizing investment.⁴⁹

These penalties can be substantial, if imposed, which occurs rarely. The power of the prohibition appears to lie in the threat of its use, rather than its actual application.

On the other hand, merely making a jeopardy investment does not threaten the foundation's overall portfolio nor does it put the foundation's tax-exempt status at risk (except in the case of flagrant and repeated violations). Further, if an investment is determined to jeopardize the carrying out of a foundation's exempt purposes, the foundation can divest of it, and the foundation can request that the applicable tax may be abated or refunded, so long as the violation was corrected within the required correction period, and the proceeds of the divestment were not recycled into another jeopardizing investment.⁵⁰

3. Program-Related Investments

a. Introduction

While the prohibition against jeopardizing investments aims to ensure that a foundation will be in a financial position to execute its charitable purposes year after year, an exception to the prohibition expressly permits a foundation to make investments that may resemble grants, and must be closely related to its charitable purposes, without regard for the investment's financial performance. I.R.C. § 4944(c) provides this exception to the jeopardy investment prohibition for "program-related investments," or PRIs. An investment will not trigger the jeopardizing investment tax, even if it is highly risky, so long as it satisfies the following three-pronged test:

- the investment's primary purpose is to accomplish one or more of the [exempt] purposes [of the foundation],⁵¹
- no significant purpose of the investment is to generate financial return,⁵² and
- no lobbying activity will be supported by it.⁵³

⁴³ See I.R.S. Priv. Ltr. Rul. 97-23-045 (June 6, 1997).

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ See I.R.S. Priv. Ltr. Rul. 94-51-067 (Dec. 23, 1994).

⁴⁷ See I.R.S. Priv. Ltr. Rul. 92-37-035 (Sept. 11, 1992).

⁴⁸ I.R.C. § 4944(a)(1) states: "If a private foundation invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes, there is hereby imposed on the making of such investment a tax equal to 10 percent of the amount so invested for each year (or part thereof) in the taxable period." The amount of the initial tax was doubled from 5 to 10 percent under the Pension Protection Act of 2006, effective for tax years commencing after August 17, 2006. The term "taxable period" means, with respect to any investment which jeopardizes the carrying out of exempt purposes, the period beginning with the date on which the amount is so invested and ending on the earliest of:

- (A) the date of mailing of a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212,
- (B) the date on which the tax imposed by subsection (a)(1) is assessed, or
- (C) the date on which the amount so invested is removed from jeopardy.

⁴⁹ I.R.C. § 4944(a)(2). Knowledge under this provision shall be found to be present if the manager had adequate facts about the investment to determine that it would be a jeopardizing investment, was aware that the investment might violate the prohibition against jeopardizing investments, and failed to make reasonable attempts to determine whether the investment was a jeopardizing investment. Treas. Reg. 53.4944-1(b)(2)(i). The application of the tax is complex. See I.R.C. §§ 4944(a)(2), (b)(1)-(2), and 4944(d)(1)-(2), as amended by the Pension Protection Act of 2006 at U.S.C. § 4944(d)(1).

⁵⁰ I.R.C. § 4944(e)(2) (stating that an investment that jeopardizes the carrying out of exempt purposes shall be considered to be removed from jeopardy when such investment is sold or otherwise disposed of, and the proceeds of such sale or other disposition are not investments that jeopardize the carrying out of exempt purposes).

⁵¹ Treas. Reg. § 53.4944-3(a)(1)(i). Qualifying exempt purposes of a private foundation are described in I.R.C. § 170(c)(2)(B), and are as follows: religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.

⁵² Treas. Reg. § 53.4944-3(a)(1)(ii).

⁵³ Treas. Reg. § 53.4944-3(a)(1)(iii).

This provision allows a foundation to allocate assets to investments that may generate little or no financial return and which, in fact, may be treated by the foundation more like grants than investments. The I.R.C. permits a foundation to treat amounts expended in connection with a program-related investment toward the statutory minimum five percent payout in the year made.⁵⁴

Because a PRI as a matter of definition must be made with financial return as an ancillary consideration, investments that are motivated by charitable objectives are clearly legal under the federal tax regulations. Determining whether an investment is a PRI, however, is not so easily done.

What is a qualifying charitable purpose?

In order to qualify as a PRI, an investment must be made primarily to further the accomplishment of the private foundation's exempt activities, and only if the investment would not have been made but for the close relationship between the investment and the foundation's exempt activities.⁵⁵ Interestingly, a qualifying investment may be made in either a tax-exempt or a taxable organization, so long as the organization provides the means by which the foundation's charitable purposes are accomplished.⁵⁶ We explore more closely below the definition of a "qualifying charitable purpose" that has evolved in the context of program-related investments.

How much financial return is permissible in a PRI?

In determining whether a "significant purpose" of an investment is the production of income or the appreciation of property, a key consideration turns on whether investors engaging in the investment solely for profit would be likely to make the investment on the same terms as the private foundation.⁵⁷ The fact that an investment produces significant income or capital appreciation does not, in the absence of other factors, offer conclusive

evidence of a significant purpose involving the production of income or the appreciation of property. The guidance under the regulations indicates that so long as the intent to produce income or appreciation did not constitute a significant reason for the investment at the time that it was made, the subsequent generation of market-rate or above-market rate returns will not disqualify the investment as a PRI.⁵⁸ A close analysis of the regulations in conjunction with the relevant private letter rulings that consider questions of permissible financial return suggests that so long as the charitable purpose of the investment constitutes the primary purpose of making it, and any financial return is secondary, the investment will qualify as a PRI. The I.R.S. looks closely for indications that a foundation is investing on terms that in one way or another are inferior to those that a purely commercial investor would accept.

What kinds of investments are permissible?

While PRIs frequently take the form of loans, they are not limited to this asset class. Credit enhancement instruments, equity investments, and real estate investments are among those that have been deemed permissible by the I.R.S.⁵⁹

b. Guidance Provided under Regulations Interpreting the Law

The Treasury Regulations issued under I.R.C. § 4944 provide clear examples of what constitutes a program-related investment.⁶⁰ These examples can be relied upon as guidance by a foundation seeking to interpret § 4944. However, they were issued in 1972 and appear almost quaint against the backdrop of the current policy and investment environment. Nonetheless, they codify the following useful points:

- A loan having a below-market interest rate to a business closely tied to the charitable purposes of the lending foundation which was unable to procure funds from conventional sources of capital at feasible rates will qualify as a PRI, even if it generates profit equal to or higher than earnings from conventional portfolio investments;

⁵⁴ I.R.C. § 4942; Treas. Reg. § 53.4942(a)-3(a)(2)(i).

⁵⁵ Treas. Reg. § 53-4944-3(a)(2)(i).

⁵⁶ Treas. Reg. § 53.4944-3(a)(2)(i) provides that a PRI may be made to organizations other than exempt organizations; Rev. Rul. 74-587, 1974-2 C.B. 162 clarifies this in finding that a qualifying PRI need not be made to a tax-exempt entity, as the entity is "merely the instrument[s] by which charitable purposes were accomplished.

⁵⁷ Treas. Reg. § 53-4944-3(a)(2)(iii).

⁵⁸ See Treas. Reg. § 53.4944-3(a)(2). See also *Plumsted Theatre Soc'y v. Comm'r*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982) (holding that potential profit will not disqualify an investment as a PRI, so long as profit is not a significant purpose of the investment).

⁵⁹ For a full list of private letter rulings approving program-related investments across asset classes, see *infra* Appendix B.

⁶⁰ A list of approved PRIs by asset class is set out at Appendix C.

- An equity investment in a business that will enable it to expand will qualify as a PRI, even if the potential for profit exists, given that the business' activities advance the charitable purposes of the foundation;
- A loan having a below-market rate of interest to a business that advances the charitable purposes of the foundation will qualify as a PRI;
- An interest-free loan to an individual to pursue an education qualifies as a PRI, where the lending foundation's charitable purposes would be advanced by making the loan;
- An investment in a low-income housing strategy insured by the Federal Housing Administration qualifies as a PRI.
- *By contrast*, an equity investment in a company that has no relationship with the charitable purposes of the foundation does *not* qualify as a PRI.

As noted, since 1972 when these examples were issued, social policy, corporate vehicles, and capital markets have evolved. The boundaries established by these examples have long since been expanded upon in practice, and some of these have been blessed by the I.R.S. through individual PLRs or revenue rulings (discussed below).

In May 2002, a working group of the American Bar Association's Section on Taxation requested the I.R.S. to consider proposed new examples.⁶¹ This request sought to modernize the interpretation of the existing law, not a change to the law itself. The Council on Foundations has also requested that the I.R.S. consider including the proposed new PRI examples. Most of these seek to codify determinations of qualifying PRIs in private letter rulings. Appendix D sets out the full text of the examples.

Definition of qualifying charitable activity

The proposed new examples seek the I.R.S.' clarification that the following activities, among others, would qualify as charitable under the PRI test: an activity conducted in a foreign country that qualifies as charitable when conducted in the United States, activities supporting economic development to recover from a terrorist attack or a natural disaster, and activity that will "lessen the burdens of government."

⁶¹ See Appendix D for the full text of the proposed examples.

Definition of "significant purpose"

In order to clarify the I.R.S.'s definition of "significant purpose," the new examples propose that the I.R.S. consider the following to qualify as program-related investments: an investment with high-return potential, a loan made at a market rate of interest, an above-market rate loan – so long as some other term of the loan is less attractive than the terms available to for-profit lenders, an equity investment in a for-profit entity that has a reasonable risk-adjusted return.

The proposed new examples would codify recent private letter rulings already issued by the I.R.S. This codification would enable foundations generally to rely upon them, and would modernize the guidance available to foundations under the Treasury regulations. To date, the I.R.S. has not responded to the request.

c. Guidance Provided Under Private Letter Rulings on Proposed Program-Related Investments and Revenue Rulings

In addition to the examples provided in the Treasury Regulations under § 4944, foundations do look for guidance in the Private Letter Rulings, or PLRs, that the I.R.S. has issued in response to specific requests from foundations seeking an affirmative exemption from the jeopardy investment tax. More than one hundred PLRs on substantive issues of § 4944(c) have been issued. With rare exception, the I.R.S. generally rules that the proposed investment is program related, which is no surprise given the careful tailoring that goes on within the request for a ruling by the foundation and its lawyers. Due to the specificity of the fact patterns under the PLRs, and their lack of precedential value, they offer only suggestive guidance to other foundations as to the I.R.S.'s disposition toward a particular set of facts; nonetheless, in the absence of better authority, they serve as general guideposts.

The body of PLRs issued by the I.R.S. includes several that address specific programmatic areas. Examples include architectural conservation, community or economic development, conservation easements, ecological preservation, and independent media in formerly closed societies. Prominent programmatic categories, though, include housing, community/economic development, and environmental and ecological matters. Each of these main categories will be discussed in turn.

Foundations may also seek guidance under § 4944 in revenue rulings issued by I.R.S. Unlike private letter rulings, revenue rulings do carry precedential value, and may be relied on broadly by taxpayers. Relevant revenue rulings are discussed below, as well.

i. Housing

Foundations have succeeded in obtaining positive rulings from the I.R.S. relating to housing investments in the United States and abroad. The investments consist of loans as well as equity investments, such as contributing monies to a fund, or buying stock in a for-profit corporation that provides housing development in blighted areas.

In each of these rulings, the investing foundation met the requirements that the investment have a close tie to the charitable purposes of the foundation, and that no significant purpose of the investment consist of generating income or the appreciation of property,⁶² for example:

- A loan at five percent to a for-profit partnership to purchase buildings in a blighted area of a city and convert the buildings to apartment complexes for low-income individuals,⁶³
- A no-interest loan to a for-profit corporation to develop 500 housing units for the working poor,⁶⁴
- An investment in a mixed-income housing project in a deteriorated area of a city.⁶⁵

Revenue rulings that consider the definition of a qualifying “charitable purpose” and have been cited in interpreting § 4944(c) include:

- the provision of interest-free loans to homeowners in a badly deteriorated urban residential area,⁶⁶
- the provision of below-market interest rate loans to low-income residents who cannot obtain mortgages at conventional lending institutions,⁶⁷
- the provision of low-income housing for the aged in an economically depressed neighborhood.⁶⁸

Perhaps the most significant guidance for housing PRIs lies in a 1996 Revenue Procedure issued by the I.R.S., which sets forth a safe harbor and a facts-and-circumstances test under which organizations that provide low-income housing are considered charitable.⁶⁹ The safe harbor requires at least seventy-five percent of the units to be occupied by people qualified as “low-income” under definitions issued by the U.S. Housing and Urban Development Department (“HUD”).⁷⁰ Given the evidence that mixed-income housing more effectively contributes to economic development than low-income housing, and the evolution of social policy accordingly, this “safe harbor” no longer reflects best practices in investing for community development.

⁶² See I.R.S. Priv. Ltr. Rul. 200408035 (Feb. 20, 2004); I.R.S. Priv. Ltr. Rul. 200331006 (Aug. 1, 2003); I.R.S. Priv. Ltr. Rul. 200331007 (Aug. 1, 2003); I.R.S. Priv. Ltr. Rul. 200331005 (Aug. 1, 2003); I.R.S. Priv. Ltr. Rul. 20031008 (Aug. 1, 2003); I.R.S. Priv. Ltr. Rul. 91-48-052 (Nov. 29, 1991); I.R.S. Priv. Ltr. Rul. 91-31-046 (Aug. 2, 1991); I.R.S. Priv. Ltr. Rul. 91-12-013 (Mar. 22, 1991); I.R.S. Priv. Ltr. Rul. 90-16-078 (Apr. 20, 1990); I.R.S. Priv. Ltr. Rul. 89-23-071 (June 9, 1989); I.R.S. Priv. Ltr. Rul. 89-23-070 (June 9, 1989); I.R.S. Priv. Ltr. Rul. 88-32-058 (Aug. 12, 1988); I.R.S. Priv. Ltr. Rul. 85-47-084 (Aug. 29, 1985); I.R.S. Priv. Ltr. Rul. 78-23-072 (Mar. 13, 1978). Further examples may be found in Treas. Reg. § 53.4944-3(b), which provides clear illustrations of acceptable program related investments in the programmatic area of housing.

⁶³ See I.R.S. Priv. Ltr. Rul. 91-48-052 (Nov. 21, 1991); See generally I.R.S. Priv. Ltr. Rul. 91-31-046 (Aug. 2, 1991); I.R.S. Priv. Ltr. Rul. 91-12-013 (Mar. 22, 1991); I.R.S. Priv. Ltr. Rul. 90-16-078 (Apr. 20, 1990).

⁶⁴ I.R.S. Priv. Ltr. Rul. 89-23-070 (June 9, 1989); I.R.S. Priv. Ltr. Rul. 89-23-071 (June 9, 1989).

⁶⁵ I.R.S. Priv. Ltr. Rul. 78-23-072 (Mar. 13, 1978).

⁶⁶ Rev. Rul. 76-408, 1976-2 C.B. 145.

⁶⁷ *Id.*

⁶⁸ Rev. Rul. 75-198, 1975-1 C.B. 157.

⁶⁹ Rev. Proc. 96-32, 1996-1 C.B. 717.

⁷⁰ HUD defines “low-income” housing as follows: eighty percent of an area’s median income, which may be adjusted to reflect economic differences and family sizes. In addition to the 75% “low income” rule, either at least twenty percent of the units must be occupied by “very low-income” residents (defined by HUD as fifty percent of an area’s median income, subject to adjustments), or forty percent of the units must be occupied by residents that do not exceed one hundred twenty percent of the area’s “very low-income” limit. Finally, up to twenty-five percent of the units may be provided at market rates to persons having incomes in excess of the low-income limit. *Id.*

ii. Community/Economic Development

Community/economic development also constitutes an important programmatic area in which several private letter rulings and revenue rulings have been issued qualifying both loans and equity investments as program-related.⁷¹ Taken together, these rulings suggest the following boundaries of permissible program-related investments in this area, *subject to meeting the conditions that the investment is closely tied to the charitable purposes of the foundation, and no significant purpose of the investment is to generate income or the appreciation of property*:

- an equity investment in a fund that invests in businesses based in low income communities, where those businesses were owned or controlled by minorities and other disadvantaged groups;⁷²
- an investment program to lend or make capital contributions to a foreign government in order to promote economic development, with the production of employment opportunities;⁷³
- a no-interest loan program to provide funds to a foreign government that would then lend the funds to local banks at below-market interest rates to promote economic development;⁷⁴
- an equity investment in a for-profit corporation that provides seed money to start-up businesses and thereby creates jobs for the unemployed and underemployed and lessen economic depression;⁷⁵
- an investment program consisting of loans and grants to community development corporations to combat community deterioration;⁷⁶

⁷¹ See I.R.S. Priv. Ltr. Rul. 200610020 (Mar. 10, 2006); I.R.S. Priv. Ltr. Rul. 200331006 (Aug. 1, 2003); I.R.S. Priv. Ltr. Rul. 200036050 (Sept. 8, 2000); I.R.S. Priv. Ltr. Rul. 199943058 (Oct. 29, 1999); I.R.S. Priv. Ltr. Rul. 199943044 (Oct. 29, 1999); I.R.S. Priv. Ltr. Rul. 199910066 (Mar. 12, 1999); I.R.S. Priv. Ltr. Rul. 98-26-048 (June 26, 1998); I.R.S. Priv. Ltr. Rul. 96-20-039 (Nov. 29, 1991); I.R.S. Priv. Ltr. Rul. 91-48-052 (Nov. 29, 1991); I.R.S. Priv. Ltr. Rul. 91-48-049 (Nov. 29, 1991); I.R.S. Priv. Ltr. Rul. 90-16-078 (Apr. 20, 1990); I.R.S. Priv. Ltr. Rul. 85-49-039 (Sept. 10, 1985); I.R.S. Priv. Ltr. Rul. 81-39-068 (June 30, 1981).

⁷² See I.R.S. Priv. Ltr. Rul. 200610020 (Mar. 10, 2006).

⁷³ See I.R.S. Priv. Ltr. Rul. 200036050 (Sept. 8, 2000).

⁷⁴ See I.R.S. Priv. Ltr. Rul. 199943058 (Oct. 29, 1999).

⁷⁵ See I.R.S. Priv. Ltr. Rul. 199943044 (Oct. 29, 1999). In the first private letter ruling to be issued under 4944(c), in 1977 the I.R.S. ruled on a proposed investment by a private foundation in a small business investment company ("SBIC") that would help a community with high unemployment rates. The I.R.S. ruled that the proposed investment would not qualify as a program-related investment on the grounds that the SBIC would be organized and operated as a for-profit company. I.R.S. Priv. Ltr. Rul. 77-42-062 (1977). This line of reasoning was soon superseded by the examples under Treas. Reg. § 53.4944-3(c), and subsequent private letter rulings.

⁷⁶ See I.R.S. Priv. Ltr. Rul. 96-20-039 (May 17, 1996).

- an equity investment in a for-profit organization that would provide economic development in a blighted area of a city;⁷⁷
- a loan to an exempt organization that combats community deterioration through the purchase and resale of parcels of land to developers in deteriorating areas of a city.⁷⁸

By contrast, the I.R.S. has ruled against a private foundation's request for a determination that its 100 percent ownership and operation of a for-profit inn located in a historic community qualify as a program-related investment.⁷⁹ While the purpose of the private foundation was to preserve, create, and promote the architectural heritage of a certain town, the I.R.S. held that the investment did not, due to its for-profit character, adequately further the foundation's charitable purposes.

The revenue rulings focused on foundation investments within the community and economic development field have determined the following activities to meet the test of a "qualifying charitable purpose":

- acquisition of an industrial park in an economically depressed community;⁸⁰
- a nonprofit small business investment company that provides low-cost or long-term loans to businesses unable to procure funds from conventional commercial sources,⁸¹
- investment in an organization funded by a U.S. government agency that supports industrial enterprises to locate new facilities in an economically depressed urban community,⁸² and, interestingly,
- the preservation or improvement of a community even if that community is not in decline, so long as the community interests served are truly public in scope.⁸³

⁷⁷ See I.R.S. Priv. Ltr. Rul. 85-49-039 (Sept. 10, 1985).

⁷⁸ See I.R.S. Priv. Ltr. Rul. 81-39-068 (June 30, 1981).

⁷⁹ See I.R.S. Priv. Ltr. Rul. 93-40-002 (Oct. 8, 1993).

⁸⁰ Rev. Rul. 76-419, 1976-2 C.B. 146.

⁸¹ Rev. Rul. 81-284, 1981-2 C.B. 130.

⁸² Rev. Rul. 76-419, 1976-2 C.B. 146.

⁸³ Rev. Rul. 76-147, 1976-1 C.B. 151.

iii. Environmental/Ecological Matters

In several private letter rulings, the I.R.S. has determined proposed program-related investments that advance environmental purposes to qualify.⁸⁴ Private foundations have made investments for environmental projects that were loans and/or grants, and in some instances, equity investments. Qualifying activities include running a farm, underwriting conservation easements, balancing biological resources with economic development, buying and maintaining ecologically significant lands, maintaining biological facilities, creating a policy research center on environmental matters, and buying an ecologically significant island.⁸⁵ Specific examples follow:

- A private foundation that operated a farm in a foreign country for the purpose of preservation and demonstration of how advanced agricultural methods may be used to improve productivity was determined to have made a qualifying program-related equity investment.⁸⁶
- No-interest or below-interest loans to developers for the purchase of environmentally sensitive undeveloped lands that were subject to development pressures were deemed qualifying program-related investments, so long as conservation easements were incorporated.⁸⁷
- Investment in ecologically and archaeologically significant land qualified as a program-related investment.⁸⁸
- Investment in a for-profit corporation that provided financing and promoted environmentally oriented businesses that would contribute to conservation and economic development in economically and/or environmentally sensitive areas within a specified region was found to qualify as program-related.⁸⁹

⁸⁴ See I.R.S. Priv. Ltr. Rul. 200343028 (Oct. 24, 2003); I.R.S. Priv. Ltr. Rul. 200222034 (May 31, 2002); I.R.S. Priv. Ltr. Rul. 200136026 (Sept. 7, 2001); I.R.S. Priv. Ltr. Rul. 94-26-044 (July 1, 1994); I.R.S. Priv. Ltr. Rul. 88-42-067 (Oct. 21, 1988); I.R.S. Priv. Ltr. Rul. 87-08-067 (Dec. 1, 1986); I.R.S. Priv. Ltr. Rul. 81-44-060 (Aug. 6, 1981).

⁸⁵ Organizations engaged in the conservation of natural resources have been recognized as exempt under I.R.C. § 501(c)(3). Rev. Rul. 70-186, 1970-1 C.B. 128; Rev. Rul. 76-204 1976-1 C.B. 152.

⁸⁶ See I.R.S. Priv. Ltr. Rul. 200343028 (Oct. 24, 2003).

⁸⁷ See I.R.S. Priv. Ltr. Rul. 200222034 (May 31, 2002).

⁸⁸ See I.R.S. Priv. Ltr. Rul. 94-26-044 (July 1, 1994); I.R.S. Priv. Ltr. Rul. 81-44-060 (Aug. 6, 1981).

⁸⁹ See I.R.S. Priv. Ltr. Rul. 200136026 (Sept. 7, 2001).

4. Mission Investments That Do Not Qualify as Program-related Investments

How should foundations think about mission investments that do not qualify as PRIs — either because making a profit is a significant purpose of the investment, or because the social objective is not adequately linked to the foundation's exempt purposes? If the investment is made at market rate, and fits within the foundation's overall investment policy, then it falls well within the prudent investor standard. The fact that social or environmental considerations were weighed along with more traditional financial analysis does not render it a jeopardy investment, nor would such considerations offer any legal basis for second-guessing the investment decision.

Alternatively, if the investment carries a lower risk-adjusted return than a market rate investment within the same asset class, a foundation may decide to make the investment in order to further its mission while still primarily intending to earn a financial return. Under these circumstances, the investment would not qualify as a PRI and, one might argue, the lower financial return could impact the foundation's ability to fulfill its long-term charitable purposes, and thereby trigger the prohibition against jeopardy investments.

We have found no legal precedent or letter rulings that specifically address these circumstances. However, based on available I.R.S. guidance to I.R.C. § 4944, we reason as follows:

1. **Donor Intent Prevails:** If the donor expressly permitted the consideration of mission-related criteria, or did not intend that the foundation constitute a permanent endowment, then neither the short- nor the long-term objectives of the foundation will be defeated by making a below-market mission investment, and the jeopardy investment prohibition will not apply;
2. **No Erosion of Value:** If the investment is at least anticipated to keep pace with inflation (after payout), then the original value of the gift has not been eroded and the foundation's ability to carry out its long-term objectives has not been jeopardized. Although the foundation's asset growth may be slower than it would theoretically have been by investing in a market rate investment, the minimum financial requirements have been met, and the trustees or directors should have the discretion to trade off the option of excess appreciation against investments that advance the foundation's mission;

3. Whole Portfolio: The risk-adjusted return of a mission investment may be cushioned by other portfolio investments so that it does not materially diminish the long-term financial performance of the portfolio as a whole. For example:

- the risk-adjusted return of the mission investment may be mitigated because it is inversely related to the risk-adjusted return of other assets in the portfolio,
- the portfolio as a whole may earn offsetting returns that at least equal the rate of inflation (after payout), or
- the mission investment may be so small as to be immaterial to the foundation's overall ability to serve its long-term objectives.

5. Summary

In summary, federal tax law applicable to private foundations permits investments with a risk/return profile that falls within the bounds of a reasonable asset allocation strategy — so long as that overall investment strategy has been developed with care and consideration for the short- and long-term needs of the foundation, and for its charitable purpose. This conclusion applies to market-rate mission investments, as well as to conventional investments that are made without consideration for advancing the charitable purpose of the foundation.

Those mission investments made with social impact as the highest priority, and with financial performance deemed to have no significant purpose, should qualify as permissible investments under the program-related investments exception to the jeopardy investment prohibition. As discussed above, the connection between the foundation's charitable purpose and the investment itself must be strong, such that the investment would not have been made but for the advancement of the foundation's charitable purposes. It is irrelevant whether the investment offers above-market, at-market, or below-market returns, or even whether it promises no return or great return, so long as (1) the investment's primary goal is to advance the charitable purposes of the foundation, and (2) investors with a pure profit motive would not invest on the same terms as the foundation. Similarly, it is irrelevant whether the investment consists of debt or equity, or whether the vehicle is an exempt organization or a for-profit entity, so long as it provides a means whereby the foundation can advance its charitable purpose.

When a foundation wishes to make an investment that relates to its mission, does *not* promise risk-adjusted market returns as compared to other investments in the same asset class, and does *not* qualify as a PRI, careful consideration must be made as to whether the investment can be made within the confines of the jeopardy investment prohibition. We have found no explicit legal guidance on this issue. However, we reason that even where the proposed investment has a high risk/return profile and the probability of loss is great, the investment will not constitute a jeopardy investment, subject to the following caveats: (1) the investment must advance the foundation's exempt purposes, and (2) investment risk must be mitigated through portfolio diversification or offset by the higher returns of other investments, such that the long-term purchasing power of the endowment as a whole is not materially impaired. In assessing the prudence of such an investment, the whole portfolio of the foundation must be considered. As a practical matter, thorough records of the investment committee's deliberations should be kept, to evidence the care undergirding a decision to invest in these circumstances.

B. STATE FIDUCIARY LAWS

1. Introduction

While fiduciary standards applicable to private foundations vary from state to state, the prudent investor rule is now broadly recognized as the most relevant to investment decisions. As developed in the courts and set out in the treatise governing the law of trusts,⁹⁰ the prudent investor rule is set forth in the Uniform Prudent Investor Act ("UPIA"), which applies to trusts, and has developed over time through interpretation by the courts and through practice. The prudent investor rule has also been adopted by the new Uniform Prudent Management of Institutional Funds Act ("UPMIFA") to apply to the management of the assets of charitable institutions, including foundations, organized as nonprofit corporations.⁹¹ In those states in which it has already been adopted, UPMIFA supersedes the Uniform Management

⁹⁰ RESTATEMENT (THIRD) OF TRUSTS (2007).

⁹¹ See discussion of UPMIFA infra Part I.B.2.

of Institutional Funds Act (“UMIFA”), which like UPMIFA applies to charities organized as corporations. While UMIFA is gradually being displaced, it is important to clarify that the older uniform act relies on the business judgment rule in setting a standard for fiduciaries. This rule holds that a court will not question the decisions made by a fiduciary so long as they are made with due care and loyalty in the exercise of “business judgment.” The duties of care and loyalty also undergird the prudent investor rule, and UPMIFA views the prudent investor standard to be consistent with — if better articulated than — the business judgment rule’s application to charitable institutions.⁹²

The relevant statutes are discussed generally below, and a close analysis of California, New York and Oregon statutory laws, legislative history, and case law appears in Appendices E-G. On the whole, case law is not well-developed in this area. Consequently, statutory law provides the best source of guidance for practitioners.

The law of fiduciary responsibility distinguishes between foundations deemed to have endowments and those foundations the assets of which are not so defined by the law. As a general matter, if a donor has specified that the assets used to establish the foundation must not be spent down, but instead must be invested to produce return adequate to fund grantmaking activities, then a legally defined endowment arises, and its fiduciaries will be required to manage it in such a way as to protect its permanent character. The law will also presume that a donor intended to establish an endowment unless explicitly stated otherwise. However, if a foundation is not specified by a donor or presumed by the law to constitute an endowment, then the institution may spend part or all of its assets down to advance its charitable purposes (the oft-invoked “if you can spend it, you can invest it” adage). It follows that a foundation that is not an endowment may invest any or all of its assets in mission-related investments.

⁹² See UPMIFA § 3 cmt.: Susan Gary, Charities, Endowments, and Donor Intent: the Uniform Prudent Management of Institutional Funds Act, 41 GA. L. REV. 1277, 1299-1300 & nn.131-140 (2007).

2. Uniform Prudent Management of Institutional Funds Act

Uniform Prudent Management of Institutional Funds Act (UPMIFA) is the most recent uniform act that governs the management of charitable funds. UPMIFA was adopted by 300 state law commissioners on July 13, 2006 at the annual meeting of the Uniform Law Commission, a national conference of lawyers that promulgates uniform laws.⁹³ UPMIFA is in various stages of adoption by individual state legislatures.⁹⁴

UPMIFA charts new territory in three major ways: first, because it uses language from UPIA, it harmonizes the uniform standards of prudence for charitable organizations regardless of their legal form as a nonprofit corporation or a trust. Second, UPMIFA sets out rules on spending from endowment funds intended by donors to have perpetual existence. And third, UPMIFA provides rules a charity, including a foundation, can use to alter a restriction imposed on a charitable donation. UPMIFA explicitly contemplates and accommodates mission investing in certain respects. A discussion of these provisions within UPMIFA’s overall standards follows.

a. Standard of Prudence

In seeking to set out a prudence standard for all charitable organization fiduciaries to follow when making investment decisions, UPMIFA — while technically applicable only to nonprofit corporations, and not to trusts — seeks to harmonize the standards for managing and investing charitable funds regardless of their corporate form. Accordingly, UPMIFA, unlike its predecessor UMIFA, incorporates the principles of trust law standards set out in the Uniform Prudent Investment Act (UPIA) relevant to charitable organizations.

UPMIFA adopts a prudence standard for investment decision-making derived from the prudent investor rule of UPIA. Investments are not judged individually, but must be considered as part of the overall investment strategy of a portfolio — a central tenet of modern portfolio theory. UPMIFA clarifies and elaborates on factors the fiduciaries of a charitable organization should consider in making investment decisions.

⁹³ The National Conference of Commissioners on Uniform State Laws (NCCUSL).

⁹⁴ As of September 21, 2008, 24 states and the District of Columbia had adopted UPMIFA (Alabama, Arizona, Colorado, Connecticut, Delaware, Georgia, Idaho, Indiana, Iowa, Kansas, Minnesota, Montana, Nebraska, Nevada, New Hampshire, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, and West Virginia), and six state legislatures were considering its adoption (California, Illinois, Maryland, Michigan, Ohio, and Vermont). UPMIFA, see <http://www.upmifa.org/DesktopDefault.aspx?tabindex=5&tabid=68> (last visited September 21, 2008).

Those relevant to mission investing include the following.

- Donor intent governs, as expressed in the gift instrument;⁹⁵
- The charitable purposes of the institution must be given precedence;⁹⁶
- The duties of care and good faith must be exercised according to the standard that an “ordinarily prudent person in a like position would exercise under similar circumstances⁹⁷”, where “similar circumstances” include the charitable context within which investment decisions are to be made, thereby inserting a consideration beyond mere risk/return analysis in determining the prudence of an investment decision.⁹⁸

UPMIFA adopts UPIA’s prudent investor standard without deviation. The statute provides eight considerations to be factored into the prudent management and investment of institutional funds:

- General economic conditions
- Possible impact of inflation or deflation
- Expected tax consequences
- Role played by individual investments within the overall investment portfolio
- Expected total return from both income and appreciation
- Other resources of the institution
- Needs of the institution to make distributions and to preserve capital, and
- Any special relationship or value of an asset to the charitable purposes of an institution.⁹⁹

It is important to note that UPMIFA explicitly carves out program-related assets from its reach. Tracking the language of I.R.C. § 4944(c), such assets are defined as those “... held by an institution primarily to accomplish a

charitable purpose of the institution and not primarily for investment.”¹⁰⁰ UPMIFA recognizes that these assets may be considered to be investments, but excludes them from the risk/return analysis that other investments must be subjected to as a matter of prudent decision-making.

b. Endowment Spending and Preservation

Frequently those in favor of mission investing argue that if it is permissible to pay out one hundred percent of a foundation’s assets to advance its charitable purposes, then it follows that it is permissible to invest in accordance with those charitable purposes — even if such investments offer lower financial returns and at the extreme, an erosion of the assets over the long term. In the case of foundations not intended by the donor to operate perpetually, this logic holds under the law. However, for a foundation deemed by law to give rise to an “endowment”, it is not permissible to invest in accordance with the foundations’s charitable purposes if the principal of the donor’s gift establishing the endowment is thereby eroded.

UPMIFA assumes that perpetual existence was intended unless a donor states otherwise. To override the uniform law’s presumption, the donor’s intent must be expressed in the gift instrument (defined as including all written documents, including electronic writings, under which a donor transfers property to a charity — including writings after the time of transfer, and excluding verbal expressions of intent).¹⁰¹ Specifically, UPMIFA presumes that the donor intended that the foundation’s assets would be managed in such a way as to produce adequate funds to distribute, while protecting the foundation’s permanent character. With the aim of preserving not only historic dollar value but the *value of an endowment over time*, UPMIFA articulates a spending rule based on the specific circumstances of the endowment fund and the charitable institution it supports, and emphasizing the “duration and preservation of the endowment fund.”¹⁰² A donor may also override the law’s presumption of permanent existence in

⁹⁵ UPMIFA § 3(a).

⁹⁶ *Id.*

⁹⁷ UPMIFA § 3(b).

⁹⁸ UPMIFA § 3(a) cmt.

⁹⁹ UPMIFA § 3(e)1.

¹⁰⁰ UPMIFA § 2(7).

¹⁰¹ UPMIFA § 2(3).

¹⁰² UPMIFA § 4(a)(1). The term “purchasing power” is not used in the provisions of the Act, but is used in its comments to express the importance of maintaining the value of the assets of the foundation over time (historic value plus inflation). By contrast, the technical meaning of “purchasing power” under accounting standards implies correlation to an index, such as the Consumer Price Index; this meaning reportedly was not intended by the Uniform Law Commission. Maintaining “purchasing power” in its technical sense may be impossible over time, and is not required by UPMIFA.

the gift instrument by specifying, for example, that the foundation's assets must be fully paid out within a certain number of years, or that a certain percentage of the historic value of the assets be paid out annually. Further, statutory law within a state that has adopted UPMIFA may alter the Act's presumption, and careful analysis should be made of state-specific law before assuming that UPMIFA's presumption will prevail.

If the legal presumption of permanent existence does hold, it is important to understand what it requires of a fiduciary. The Drafting Committee of UPMIFA discussed establishing a bright-line rule for annual payout to protect against overspending an endowment and thereby compromising its perpetual character, but did not agree that this was necessary. As a result, the text of the Act does not include such a rule, but instead provides an optional provision that individual legislatures may consider. This provision includes a presumption of imprudence if a charity spends more than seven percent of an endowment fund in any one year, based on a rolling average of the endowment's market value during the three or more years immediately preceding the year in question.¹⁰³

The presumption may be rebutted by an endowment's managers if circumstances in a particular year render expenditures beyond seven percent prudent, such as prior years of frugal payout.¹⁰⁴ For example, in a year in which a foundation generates investment returns in excess of its target rate of return (adjusted for inflation), and assuming that target were reasonable, we believe it would be prudent for it to exceed a seven percent payout. As noted by the Reporter to UPMIFA, "Public policy may favor increased spending for the public good...spending at an even higher rate [than the requisite five percent] may be appropriate for a charity's purposes and for the public good."¹⁰⁵ This limitation on spending poses an additional reason why foundations that seek to maximize their social impact should consider using their investments, in addition to their payout, to advance their charitable objectives.

3. Uniform Management of Institutional Funds Act

The Uniform Management of Institutional Funds Act ("UMIFA"), promulgated in 1972, has been adopted by all the states and the District of Columbia, with the exception of Alaska and Pennsylvania.¹⁰⁶ UMIFA itself modernized outdated (and highly conservative) fiduciary laws applicable to nonprofit corporations. As noted above, UMIFA will be superseded by UPMIFA as individual state legislatures adopt the more recent uniform act.

At the time of UMIFA's enactment, charitable institutional funds were conservatively invested in bonds and fixed-income instruments considered to provide a low-risk, low-return, and dependable income. UMIFA embraced total-return investing, which freed charitable institutions to invest in higher-return investments less subject to the effects of inflation over time.

UMIFA requires the boards of charitable institutions to invest endowment assets with care and prudence. UMIFA relies on the business judgment rule that derives from corporation law in setting a standard for fiduciary responsibility. This rule, which is consistent on the whole with the prudent investor standard, holds that a court will not second-guess a board's decision-making, as long as due care and prudence are employed. The standard set out requires consideration for "... the long- and short-term needs of the institution in carrying out its ... charitable ... purposes."¹⁰⁷ While UMIFA does not explicitly permit or prohibit mission investing, it does allow the board to consider the charitable purposes of the institution in making investment decisions. We conclude that UMIFA allows ample room for investing at *or below* market rate in advancement of a foundation's mission.

¹⁰³ UPMIFA § 4(d). For an authoritative drafting history of the Act, see Gary, *supra* note 92, at 1314 n.211 (for information on the optional provision). Prof. Gary served as the Reporter to the Drafting Committee of UPMIFA.

¹⁰⁴ UPMIFA § 4 cmt.

¹⁰⁵ Gary, *supra* note 92, at 1314 & n.212.

¹⁰⁶ See Website of the Uniform Law Commissioners, http://www.nccusl.org/update/uniformact_factsheets/uniformacts-fs-umifa.asp (last visited Aug. 10, 2008).

¹⁰⁷ UMIFA § 6.

4. Uniform Prudent Investor Act

The Uniform Prudent Investor Act (UPIA), issued in 1994, governs the investment of private trust assets — not only charities (including foundations) organized as trusts. Unlike UMIFA, UPMIFA does not supersede UPIA.

While UPIA's provisions technically apply to foundations organized as trusts, its standards of prudence nonetheless may offer guidance to foundations organized as nonprofit corporations. Those standards may also be found in other state laws governing trusts, as well as in the Restatement (Third) of Trusts, the legal treatise that, in the absence of statutory and case law, provides guidance on principles of trust law. In any case, as noted above, UPMIFA incorporates the prudent investor standard of UPIA.

When UPIA was put forward in 1994, it sought to modernize the prudent investor standard by adopting a modern portfolio approach to investing trust assets. Investment decisions must be made with reasonable care,¹⁰⁸ due loyalty,¹⁰⁹ and within the context of the overall investment strategy of the portfolio.¹¹⁰ The diversification of investments is required.¹¹¹ Notably, risk and return objectives must be considered in light of their suitability for the individual trust.¹¹² Further, the act requires a trustee to consider “all ... circumstances” relevant to the trust or its beneficiaries in making investment and management decisions. Among the circumstances enumerated is an asset's special relationship or value to the purposes of the trust or to its beneficiaries.¹¹³

¹⁰⁸ UPIA § 2(a).

¹⁰⁹ UPIA § 5.

¹¹⁰ UPIA § 2(b).

¹¹¹ UPIA § 3.

¹¹² UPIA § 2(b).

¹¹³ UPIA § 2(c)(8). The other general economic conditions include the possible effect of inflation or deflation; the expected tax consequences of investment decisions or strategies; the role that each investment or course of action plays within the overall trust portfolio; the expected total return from income and the appreciation of capital; other resources of the beneficiaries; and needs for liquidity, regularity of income, and preservation or appreciation of capital. UPIA § 2(c)(1)-(7).

This language is consistent with an interpretation that the mission of a charitable trust, and the sole interests of its beneficiaries (in this context, those benefited by the foundation's grantmaking), must be considered by the prudent trustee in making investment decisions. However, UPIA appears to challenge this interpretation explicitly in a comment to its provision imposing a duty of loyalty on a trustee, in which a trustee is required to “invest and manage the trust assets solely in the interest of the beneficiaries.”¹¹⁴ The comment reads:

No form of so-called “social investing” is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries — for example, by accepting below-market returns — in favor of the interests of the persons supposedly benefited by pursuing the particular social cause.¹¹⁵

This comment provides a gloss on the duty of loyalty and the fiduciary's responsibility to act in the sole interests of the trust beneficiaries, which is defined here exclusively as a matter of maximizing investment return. But clearly the duty of loyalty owed by a foundation trustee is distinct from that owed by the trustee of a private trust flowing to the benefit of an individual or group of individuals. Loyalty to the foundation must also take into consideration the charitable purposes of the trust.

Accordingly, an investment by a charitable trust in an asset that delivers below-market returns should not violate the duty of loyalty under UPIA, so long as that investment advances the charitable purposes of the trust (and is taken with due care and prudence). In such a case, the conflict anticipated by UPIA will not arise, and the trustee will not have acted disloyally. For example, if a charitable trust has as its exempt purpose the economic development of inner cities in the United States, a low-interest

¹¹⁴ UPIA § 5.

¹¹⁵ UPIA § 5 cmt. 4 (citing an article by the reporter to UPIA).

loan to a local retail enterprise that targets inner-city entrepreneurs and consumers would constitute a below-market social investment, but it would not compromise the interests of the trust's beneficiaries. That said, the same trust would not act within the duty of loyalty if it were to invest in a below-market asset that flowed to the benefit of those beyond the scope of the trust's charitable purpose. For example, if a foundation focused on animal rights in the United States were to make a low-interest loan to a microfinance institution serving the rural poor of Haiti, it would violate the duty of loyalty. In that instance, the trust would forego income without benefiting the trust's defined beneficiaries.

The Restatement (Third) of Trusts grapples with this comment to UPIA's section on the duty of loyalty in a discussion of the duty as it interplays with the prudent investor standard.¹¹⁶ Specifically with respect to investing for charitable trusts, the treatise states that "... social considerations may be taken into account in investing the funds of charitable trusts to the extent the charitable purposes would justify an expenditure of trust funds for the social issue or cause in question or to the extent the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust."¹¹⁷

In conclusion, while the duty of loyalty owed to a trust by its trustees applies broadly to all trusts, regardless of their beneficiaries, the interpretation of the duty must be parsed according to who the beneficiaries of a trust may be. The prohibition in UPIA against below-market social investing clearly applies to non-charitable trusts, as distinguished from a charitable trust pursuing its charitable purposes through its investment activity. As noted by one leading scholar,

"Traditionally, the view has been that the trustee's duty relates only to the beneficiaries' financial interests. Yet nothing in the duty of loyalty requires the trustee to exclude consideration of a beneficiary's non-financial interests."¹¹⁸ Said another way, in making investment decisions, a charitable trustee may consider non-financial considerations, including the charitable purposes of the foundation itself.

A state-specific analysis of current state fiduciary laws in each of California, New York, and Oregon and how they inter-relate with federal tax law relevant to mission investing in each of California, New York, and Oregon occurs at Appendices E-G. These case studies illustrate the complexity of the law, as well as its flexibility in permitting mission investing.

¹¹⁶ RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. f (2007), referring to § 90 cmt. c (2007).

¹¹⁷ *Id.*

¹¹⁸ Susan N. Gary, *Is Mission Investing Prudent?* (May 2008) (unpublished manuscript delivered on May 8, 2008 to New York University School of Law's National Center on Philanthropy and the Law, on file with author and FSG Social Impact Advisors).

Part II: Foundation Mission Investing in Practice

A. FIDUCIARY RESPONSIBILITY REDEFINED

U.S. foundations range broadly in their interest in and use of mission investing as an additional tool to advance their philanthropy. A few pioneering foundations set out to harness their investments as a tool for advancing their missions more than a decade ago, and defined their fiduciary responsibility accordingly, such as the F.B. Heron Foundation and the Jessie Smith Noyes Foundation. Others pioneered forty years ago with the particular strategy of program-related investments. These included the Ford Foundation, soon followed by the John D. and Catherine T. MacArthur Foundation, and the Packard Foundation. By contrast, many foundations continue to view their investment activity as entirely separate from their grantmaking. This wide spectrum of practice reveals the law's flexibility in permitting a variety of approaches to managing foundation assets. In fact, the legal definition of fiduciary responsibility continues to evolve as foundations recognize the opportunity to align their investment and grantmaking activity, and along with the market's development of market-rate investment products that catalyze – or at least consider – environmental and social impact.

Prominent examples of private foundations with well-developed strategies for aligning investment and grantmaking activity illustrate the variety of approaches foundations take to mission investing. **The F.B. Heron Foundation** is a leader in the field of mission investing both by example and by advocacy. Heron's board determined in 1996 to harness the foundation's investments to advance the charitable goals of asset building and community economic development. The board interpreted its fiduciary responsibility to require that it manage the foundation's assets to maximize social impact, and not to maximize financial performance alone. As former board chair William Dietel has written: "...mission stewardship challenges board members to do more than keep foundation assets from jeopardy. It asks board members to govern in a way that maximizes foundations' overall effectiveness"¹¹⁹ Since 1996, the

¹¹⁹ WILLIAM M. DIETEL, THE F.B. HERON FOUNDATION, MISSION STEWARDSHIP: ALIGNING PROGRAMS, INVESTMENTS, AND ADMINISTRATION TO ACHIEVE IMPACT (2007), available at http://www.fbheron.org/documents/ar.2006.viewbook_mission_stewardship.pdf.

foundation has built its staff expertise and engagement in mission investing, as well as its commitment to serving as a leading advocate of mission investing.¹²⁰ As of December 31, 2007, the foundation had an allocation of twenty-six percent of its assets to mission investments across the spectrum of asset classes, including program-related investments. Market-rate mission investments constituted eighteen percent of the foundation's assets. The foundation anticipates increasing its allocation to mission investments to fifty percent over time.

As one example of Heron's leadership, the foundation recently announced the launch of an index fund that screens for companies having a positive impact on community development in underserved areas across the United States. Having created the index for its proprietary use in 2004 in order to invest a portion of the foundation's portfolio in companies serving low- and middle-income communities, Heron proved that it could achieve market-rate returns by investing according to the index. With the aim of providing a product to the field at large that would both achieve market-rate financial returns and have positive social impact, the foundation announced in April 2008 the launch of the U.S. Community Investing Index and the development of an exchange-traded security fund for the index. The index consists of 340 companies out of the S&P 900's universe.¹²¹

Another indication of Heron's commitment to mission investing and its leadership in the philanthropic arena occurred early in 2008, when Cambridge Associates, the pre-eminent investment consulting firm to the foundation field, announced its launch of a mission-investing division with support from the Heron Foundation, Meyer Memorial Trust, and the Annie E. Casey Foundation. The significance of this development cannot be overemphasized. Historically, many traditional investment consultants and investment advisors to foundations have been reluctant to advise their clients

on mission investing — product supply has been scarce, and investment results uncertain. The fact that the leading investment consultant to U.S. foundations has recognized the importance of mission investing and has strong client interest in such products signals the much broader acceptance of this approach to investing by foundations today.

The **Jessie Smith Noyes Foundation** determined to harmonize its investments thoroughly with its mission early in the 1990s, and interprets its fiduciary responsibility to require that it invest consistently with its grantmaking priorities.¹²² The foundation focuses on the environment and reproductive health. In order to invest proactively to advance its charitable purposes, the foundation established its own venture capital fund, the Blue Dot Fund, which invests in green technology and clean business strategies. Hedge fund investments are no longer made due to the lack of transparency. Legal concerns have never slowed it down in engaging in mission investing, which is consistent with the board's determination that its fiduciary duties require it to invest in accordance with its charitable goals where possible.

More recently, new energy has been infused into the mission investing field by foundations seeking to leverage their investments to advance their charitable goals. For example, the **W.K. Kellogg Foundation** announced a \$100 million allocation to mission investing in October 2007, with the goal of maximizing social return on its investments. A mix of market-rate and below market-rate investments (PRIs) is contemplated, while \$75 million of this amount will fund U.S.-based strategies and \$25 million will fund African-based strategies consistent with the Kellogg Foundation's grantmaking priorities.

¹²⁰ SOUTHERN NEW HAMPSHIRE UNIVERSITY, A CASE STUDY: EXPANDING PHILANTHROPY – MISSION-RELATED INVESTING AT THE F.B. HERON FOUNDATION (2007), available at http://www.fbheron.org/documents/snhu_heron_casestudy.pdf.

¹²¹ The Index is available under the ticker CMTYIDX.

¹²² For details of the Jessie Smith Noyes Foundation's well-developed investment policy statement, including its definition of fiduciary responsibility, see <http://www.noyes.org/investpol.html> (last visited July 31, 2008).

The **Ford Foundation** is the grandfather of PRI makers, having pioneered the use of PRIs in 1968 (the 1969 Tax Reform Act's inclusion of the program-related investment exception responded to the Ford Foundation's use of this novel investment approach). Now forty years later, the Ford Foundation has invested more than \$400 million in PRIs to support the work of its grantees. The foundation caps interest rates on its loan PRIs at one percent, and may cap any equity investment profits as well, as a means of both supporting its investees and clearly evidencing that no intent to profit from the PRI is present.

The **David and Lucile Packard Foundation** has long had a strong commitment to program-related investments, having made its first loan in 1980 under its conservation program. The foundation primarily engages in PRIs with prior grantees, to ensure a close relationship with its PRI borrowers as a means of mitigating the risk of these investments. The foundation's PRI budget is segregated out from its endowment assets, and is capped at three percent of assets. The foundation currently sets interest rates at below market on PRIs that take the form of loans, and as a result avoids concerns about qualifying its loan PRIs under the I.R.S.' prohibition against income as a significant purpose of a PRI. The foundation does not currently have any equity PRIs.

Similarly, the **John D. and Catherine T. MacArthur Foundation** has served the field as a leader in deploying program-related investments to expand the impact of its grantmaking.¹²³ Since 1983, MacArthur has invested \$214 million in PRIs through loans to a variety of organizations working in the foundation's programmatic areas, including women's health, environmental conservation, education, and independent media.

The **Meyer Memorial Trust** has a well-developed mission-related investment strategy, the centerpiece of which consists of program-related investments. Since beginning operations in 1982, the **Meyer Memorial Trust** has approved more than \$27 million in debt and equity program-related investments to support projects related to the charitable objectives of the trust, including Oregon-based economic development, affordable housing, environmental protection and the arts. The trust has also committed over \$40 million cumulatively to risk-adjusted market rate mission investments since it commenced operations. In addition, the trust has become a national advocate for mission investing. Meyer has joined the Heron Foundation and the Anne E. Casey Foundation in spearheading the "2% Campaign", which calls on foundations nationally to devote up to two percent of their assets to mission-related investments in an effort to create a national pool of \$10 billion toward mission investing.

The **Annie E. Casey Foundation** implemented a Social Investment Program in 2002 that adopts three investment approaches to support the foundation's grantmaking focus on vulnerable children and families. These approaches include mission-related deposits, program-related investments, and mission-related investments. The asset classes in which the foundation has invested include deposits, low-interest loans, guarantees, and private equity. With an inaugural allocation of \$6 million, the Social Investment Portfolio was valued at over \$42 million in commitments as of October 2007. This represented approximately 1.3 percent of the foundation's assets, which were valued at \$3.326 billion as of December 31, 2007. In addition, the foundation has provided leadership to the philanthropic field in its grantmaking to support the development of mission investing. The foundation reportedly has not encountered legal obstacles in establishing its social investing program.

In the case of a long-term investor such as a foundation, the environmental, social, and governance ("ESG") impact of corporate behavior arguably should be taken into account by the prudent fiduciary to the extent that this impact affects the long-term value, risk and return

¹²³ See MacArthur Foundation, Human and Community Development: Program-Related Investments, available at http://www.macfound.org/site/c.IKLXJ8MQKrH/b.948589/k.D3BA/Domestic_Grantmaking_Program_Related_Investments.htm (last visited July 31, 2008).

of the investment.¹²⁴ The **Nathan Cummings Foundation**, for example, has long interpreted its fiduciary responsibility to require that it engage in shareholder activism. In addition to voting its proxies actively, the foundation also files shareholder resolutions focusing on ESG issues as part of its approach to active ownership. Through filing shareholder resolutions and engaging in dialogues with the companies it owns, the foundation actively seeks to encourage the companies it invests in to consider the environmental and social impact of their activities on the basis that this reflects good risk management. Negative screens other than tobacco activities are not employed. Investments in sustainable forestry strategies and LEED-certified real estate have been made not as a matter of aligning investments with mission, but in the belief that these are good investments that will generate strong financial returns. The **KL Felicitas Foundation** adds a fourth category into its sustainability considerations – “spiritual indicators” – when it considers investments.¹²⁵ While this may strike some as ambiguous, the foundation has developed careful metrics to elaborate on its objectives and performance measurements in investing according to “ESGS” concerns.

Many foundations – among them, large and prominent philanthropic institutions – continue to bifurcate their investment policy from their grantmaking priorities. In some cases, this split devolves from a conscious decision based on the philosophy that the social impact of investments is minimal when compared with the impact of grantmaking. It follows that they will then interpret their fiduciary responsibility as a matter of maximizing investment returns, the better to fuel the grantmaking budget. The more conservative of these foundations may assume a trade-off between return and social impact of an investment, while developments in the market may not continue to support that assumption.

¹²⁴ In 1995, a report issued by Freshfields Bruckhaus Deringer for the United Nations Environmental Programme Finance Initiative concluded that, with respect to fiduciary duty under US law, “While there continues to be a debate about the exact parameters of the duty, there appears to be a consensus that, so long as ESG considerations are assessed within the context of a prudent investment plan, ESG considerations can (and, where they affect estimates of value, risk and return, should) form part of the investment decision-making process.” FRESHFIELDS BRUCKHAUS DERINGER, A LEGAL FRAMEWORK FOR THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT 114 (2005), available at http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf.

¹²⁵ For details on the Felicitas Foundation’s mission investment policies, see http://www.klfelicitasfoundation.org/work/invest_strat/index.php (last visited July 31, 2008).

And even one of the most visible adherents to this philosophy — The **Bill & Melinda Gates Foundation** — screens its investment portfolio for tobacco, and engages in program-related investments.

Similarly, the **Rockefeller Foundation**, which has historically taken a conservative approach to its investment activity, screens out investments in companies “whose primary activity is related to tobacco.” The foundation also invests in companies that have “social value” that may advance its grantmaking priorities (such as renewable energy and sustainable forestry practices), and engages in program-related investments.¹²⁶

Other foundations hesitate to engage in mission investing out of a concern that it is overly complicated. Mapping out an investment policy that includes not only risk and return analysis, but also an analysis of social impact, may invite a host of complexities that foundation staff and boards may hesitate to assume. Still others bump up against the complexities of negotiating PRIs and determine that they lack the skill at the staff level to engage in the difficult and frequently expensive process of structuring a transaction. One strategy to offset the expense associated with negotiating PRI documentation is to develop standardized documentation that can be used deal after deal with only modest modifications tailored to specific transactions. Both the Heron Foundation and the Packard Foundation have adopted this approach.

With respect to payout and its implications for mission investing, foundations have the legal authority to spend down their assets over time if this authority is provided in their constitutive documents, or if statutory law does not otherwise deem that the donor intended to create a permanent vehicle. An analysis of the articles of incorporation or the trust instrument will inform the foundation as to whether or not such a provision was included. Some high-profile foundations have determined

¹²⁶ The Rockefeller Foundation has issued a set of “Social Investing Guidelines” that stops short of committing the foundation to any particular policy, but notes that the foundation may use positive and negative social screens, and engage in proxy voting. THE ROCKEFELLER FOUNDATION, SOCIAL INVESTING GUIDELINES, available at http://www.rockfound.org/about_us/social_investing_guidelines.pdf (last visited date). See also Charles Piller, *Foundations Align Investments with Their Charitable Goals*, L.A. TIMES, Dec. 29, 2007, at C1.

to spend down over a fixed amount of time, such as the Bill & Melinda Gates Foundation, Atlantic Philanthropies, and the Belden Fund. This determination may be driven by a founder's desire to avoid establishing a self-perpetuating bureaucracy, by a sense of urgency about addressing contemporary social ills, or by other impulses. Such a foundation has full latitude under the law to invest in accordance with its mission, regardless of whether financial returns are maximized.

B. EMERGING PRACTICES IN PHILANTHROPY: SOCIAL ENTREPRENEURSHIP

While we believe that foundations can make a powerful contribution toward social impact through their investing, we also recognize that private enterprise is increasingly called on to advance traditionally philanthropic objectives. Side by side with the rapid development of mission investing vehicles, entrepreneurial philanthropists may have limited patience for the confines of the federal tax laws on foundations with respect to for-profit activities. The development of the Omidyar Network, with both a traditional foundation and a for-profit company that invests in “double bottom line” strategies, exemplifies a new form of philanthropy that seeks to harness the discipline and rigor of the private sector to advance social change by investing in for-profit entrepreneurs having social intentions. The Rockdale Foundation, a funder of microfinance institutions and strategies, is embedded in a similar “network” of vehicles that deploy both traditional philanthropic solutions and more innovative social investment solutions to address global poverty. The Rockdale Foundation's grantmaking has a symbiotic relationship with the investment activity of its affiliate Gray Matters, a for-profit company that invests in social enterprises targeting the bottom of the pyramid.

Foundations can support these emerging philanthropic forms and activities through both their investment and their grantmaking activities. The Mannweiler Foundation, for example, supported a project to develop a new legal form known as the L3C, or low-profit limited liability corporation, designed to ease the legal complexities of investing in program-related investments.¹²⁷ The Rockefeller Foundation has developed a social financing grantmaking program to catalyze private sector solutions to social problems globally.¹²⁸ A more recently established foundation, KL Felicitas, takes an entrepreneurial approach to its philanthropy in focusing on supporting social enterprises around the world. Its commitment to harnessing sustainable economic solutions to address social problems permeates its investment policy, which is closely aligned with its philanthropic goals.

While our legal system is designed to embrace change slowly and cautiously, practice chafes against its conservatism and insists on moving forward with new solutions. As practice evolves, so, too, eventually does the law. The philanthropic field can look forward with confidence to new and emerging practices that insist on the link between philanthropy and the private sector. Mission investing provides one effective expression of that link.

¹²⁷ Legislation adopting the L3C as a new corporate form entered into force in Vermont on April 30, 2008. H. 775, 2008 Gen. Assem. (Vt. 2008).

¹²⁸ The Impact Investing work of the Rockefeller Foundation works to integrate program-related investing into the grantmaking of the foundation, build intermediation in the field, and foster the mission investing field generally.

Part III: Recommendations

Now almost forty years after the Tax Reform Act of 1969, the time is ripe to modernize federal tax laws relevant to investing foundation assets. Similarly, state laws could be clarified to permit mission investing explicitly, rather than implicitly. But even without changes to the relevant laws and guidance issued under them, donors and foundation boards can take practical steps to ensure that their investment policies fulfill their charitable objectives, while complying with the law.

A. LEGAL CLARIFICATION

Greater clarity in the law would ease the compliance burden of mission investing on foundation staff, trustees, and legal and tax regulators, without compromising the policy objectives underlying legal restrictions on fiduciaries to ensure that tax-exempt dollars are well-deployed for charitable purposes. The following suggestions map some ways in which the law could be effectively clarified.

1. Federal Tax Law

The confusion encountered by foundations seeking to invest within the parameters of the prohibition against jeopardy investments and its program-related exception is evidenced by the more than one thousand requests for private letter rulings interpreting § 4944 of the I.R.C. We must assume that for every foundation that makes the effort to seek legal clarification through a private letter ruling, many other foundations are deterred from doing so by the expense and delays involved. Others may elect to take the legal risk of engaging in mission investing without the comfort of clarity that their investment is fully in compliance with federal tax law. Over one hundred of these have sought substantive guidance on program-related investment qualification. This burden encompasses the legal expenses incurred by those foundations requesting guidance, or in some cases, the charitable institutions receiving program-related investments from them;¹²⁹ and the delays incurred in implementing an investment strategy or – in the worst case – foregoing an investment opportunity that would advance the foundation’s charitable purpose; and staff time that might be better allocated if the law were clearer. The burden on the I.R.S. in responding to requests for private letter rulings must also be considered.

¹²⁹ Foundations frequently request that the charitable institution in which they will invest through a PRI bear the legal burden of preparing documentation and obtaining a private letter ruling.

Legal clarification of § 4944 would ease the interpretive task faced by a foundation when contemplating a program-related investment that does not fall squarely within one of the examples issued in 1972. The I.R.S.’ consideration of publishing new examples under both the jeopardizing investment prohibition and the program-related investment exception (as requested by the American Bar Association and the Council on Foundations) heralds one approach to modernizing and clarifying the law that would require limited intervention. This would require no legislative action, and would clarify what the I.R.S. considers to be permissible investment activity. It would be immensely helpful to the compliance burden foundations face in determining whether a particular investment will qualify as a PRI if the I.R.S. were to act on this request and more modern examples were issued.

For example, the guidance on what qualifies as a charitable purpose for a housing PRI¹³⁰ is now more than a decade old, and social policy has long outpaced its definitions. We have learned in the interim that successful housing development projects incorporate mixed-income residents, including middle-income residents, yet the guidance has not been updated to reflect contemporary housing policy. The result is that foundations seeking to make impactful program-related investments in this field must either act beyond the scope of the guidance, and risk regulatory penalty, or seek a private letter ruling on each individual investment they seek to make, causing delays that may result in missed opportunities to support worthy projects, or worse, the collapse of projects altogether for lack of capital.

Some have suggested that § 4944 be abolished altogether.¹³¹ Given that fiduciary principles of good faith and investment prudence imposed on foundations by individual state law would continue to apply, it has been argued that § 4944 of the I.R.C. adds little protection above and beyond that of state law. And, as noted by one legal scholar, the I.R.S. would still retain the authority to withdraw a foundation’s exempt status in a case of abuse if it determined that the foundation had acted beyond the scope of its charitable purposes.¹³²

However, abolition of § 4944 would also remove the safe harbor of the program-related investment, which has been imported into the laws of most states. Unless it were preserved in the I.R.C. otherwise, this would remove a useful tool that foundations have to support investment strategies that advance their social impact. Further, the limited enforcement capacity of the state attorneys general argues against removing this federal oversight tool. Moreover, the current environment in the U.S. Senate and at the I.R.S. is unfavorable to relinquishing oversight authority over private foundations generally. Confused (and confusing) as the law may be, the current concern for abuses of charitable vehicles expressed by the Senate Finance Committee and the House Ways and Means Committee¹³³ indicates that the time is not ripe for repeal.

2. State Law

Ideally, state laws governing the investment of foundation assets would be amended to permit mission investing clearly and explicitly. A uniform law — or, incrementally, individual state laws — that explicitly permits foundation boards to consider not only risk and return, but also an investment’s impact on a foundation’s charitable objectives, would help to clear the legal haze around mission investing. While a close parsing of UPMIFA and UPIA permit a reasoned conclusion that they permit mission investing, greater certainty would be achieved by a provision that set out clearly that mission investing is permissible within a framework of prudent investment. Such legislation would not invalidate the careful work surrounding the prudent investor standard that has developed over decades, but would add an explicit recognition of non-financial considerations within the broader context of fiduciary responsibility. This change would also have the benefit of bringing state law into accord with the increasingly popular practice of considering the social impact of foundation investments.

¹³⁰ See *supra* notes 69-70 and accompanying text.

¹³¹ Some scholars and practitioners have called for a repeal of I.R.C. § 4944 as unduly burdensome. See, e.g., Joel C. Dobris, SRI – *Shibboleth or Canard (Socially Responsible Investing, That Is)*, 42 REAL PROP. PROB. & TR. J. 755 (2008); Schmalbeck, *supra* note 20, at 108.

¹³² Schmalbeck, *supra* note 21, at 109.

¹³³ The Senate Finance Committee and the House Ways and Means Committee have both sought in recent years to extend federal regulation of nonprofit entities, including private foundations. Two recent concrete results of the efforts relevant to foundations include an overhaul of Form 990-PF, and the enactment of the Pension Protection Act of 2006.

B. FOUNDATION INVESTMENT PRACTICES AND POLICIES

While foundations continue to navigate current law, donors wishing their philanthropic vehicles to engage in mission investing can provide explicit guidance to boards overseeing those foundations. By doing so, donors can position foundation boards to harness their investments to advance their social impact, while navigating the fiduciary and tax laws as efficiently as possible.

Given the deference paid by state fiduciary laws to the expressed intent of a donor, a key opportunity for facilitating the implementation of a foundation's investment policies occurs at the stage of drafting a foundation's constitutive documents. If a donor wants the foundation to align its investments with its charitable purposes, she can express this in writing. Such a statement might authorize trustees or directors to take social and environmental considerations into account in making investment decisions, or if the donor is so inclined, might require them to do so. The donor might also specify whether and to what extent financial returns may be sacrificed to serve mission objectives, and whether tools such as screening, proactive investments, or shareholder advocacy are authorized or encouraged.

Similarly, if the donor does not wish the foundation to exist in perpetuity – the default position of state fiduciary laws – she can set out this intent in specific terms (number of years in which the foundation must spend its assets, or a percentage pay-out per year) or merely contradict the law's presumption that she is creating an endowment (no intention of perpetual existence). Clearly, the greater the detail provided in the constitutive documents, the clearer the board and staff of the foundation will be as to what they must and can do to fulfill the donor's intent.

Best practices require a foundation board to develop a written investment policy statement to set the context within which investment decisions will be made. An investment policy statement should accomplish the following objectives:

- describe the investment goals, the required rate of return, and the target rate of return for the foundation's assets;
- describe an appropriate risk posture for the investment of the foundation's assets;
- establish investment guidelines regarding the diversification of assets and selection of investment managers; and
- specify the criteria for evaluating the performance of the investment managers and the portfolio as a whole.

An investment policy statement for a foundation that seeks to align its investments with its charitable purposes may specify, for example,

- that certain defined corporate activities will not be invested in (for example, a foundation that has as its charitable purpose combating climate change might wish to avoid investing in extractive industries);
- that certain defined corporate activities tied to the charitable purposes of the foundation will be sought out for investment across all asset classes, or within defined asset classes;
- any relevant guidelines for the selection and evaluation of investment managers;
- that program-related investments will be sought out either generally or at a targeted percentage of the foundation's assets.

In the case in which a foundation cannot, or chooses not, to spend down, and must abide by the legal restriction to manage investment assets to maintain its historical value or its value over time, investment decisions must be made to achieve returns sufficient to generate adequate grantmaking resources. Given the potential presumption that spend-out of more than seven percent is imprudent, a foundation may wish to address the use of excess investment returns by establishing a special provision for their payout in its investment policy statement.

An example of an investment policy statement for a foundation seeking to engage in mission investing is provided at Appendix H.

Lastly, and specific to program-related investments, a foundation should be careful to record the due diligence it exercises in determining to make such an investment. The board minutes recording authorization of a program-related investment should spell out the close relationship between the charitable purposes of the foundation and the investment, and the conclusion that the financial return on the investment did not constitute a significant purpose of the investment at the time the board determined to make it.

Part IV: Conclusion

Current law provides ample room permitting foundation fiduciaries to consider not only fundamental concerns for risk and return, *but also* the impact of the investment on the charitable purposes of the foundation. As rapidly as the practice of mission investing grows and new investment vehicles develop, pioneering foundations increasingly adopt a definition of fiduciary responsibility that includes not only consideration for the risk and return of a foundation's investments, but also for whether those investments are consistent with the foundation's charitable mission. This definition of prudent investment is well-grounded in practice, and is permissible – although not yet required – under relevant laws. Historically in the U.S. common law system, practice pulls the law reluctantly toward modernization. The law pertaining to investment practices – and more specifically, to mission investing by U.S. foundations – is no exception.

While we do not believe that the law currently supports any statement stronger than that mission investing is permissible, we note that best practices in foundation investing are rapidly evolving. Increasingly foundation boards believe that they have a practical obligation — if not yet a legal one — , as well as an opportunity, to consider not only the expected risk and return of a foundation's investments, but also the potential impact of those investments to advance (or corrode) a foundation's charitable mission.

And finally, we note that fiduciary duty is grounded in normative practice. As more and more foundations engage in mission investing, the definition of prudent investment — embedded as the legal concept of “prudence” is in the reality of common practice — may well cross the line from merely *allowing* to eventually *requiring* the good fiduciary to consider risk, return *and* alignment with a foundation's charitable mission.¹³⁴

Appendix A

Examples of Jeopardizing and Non-Jeopardizing Investments as set out in Internal Revenue Manual Private Foundations Handbook (04-30-1998)

¹³⁴ As early as 1997, the argument was made by exempt organizations counsel Bill McKeown that “In order to fulfill their responsibility to see that the corporation [foundations organized as nonprofit corporations and other nonprofit organizations] meets its charitable purposes, [fiduciaries] may have a duty to consider whether their investment decisions will further those charitable purposes, or at least not run counter to them.” William B. McKeown, *On Being True to Your Mission: Social Investments for Endowments*, 6 J. OF INVESTING 71, 71-78 (1997). That assertion can be rooted no more affirmatively than in the conditional tense now than it was a decade ago, if one is limited to a strict interpretation of the law. Practice, however, is another matter. See also United Nations Environmental Programme Finance Initiative *supra* note 125 (espousing a value-driven investment theory consistent with our analysis).

Example 1:

A is a foundation manager of B, a private foundation with assets of \$100,000. A approves the following three investments by B after taking into account with respect to each of them B's portfolio as a whole, an investment of:

- \$5,000 in the common stock of corporation X
- \$10,000 in the common stock of corporation Y
- \$8,000 in the common stock of corporation Z

Corporation X has been in business a considerable time, its record of earnings is good, and there is no reason to anticipate a diminution of its earnings. Corporation Y has a promising product, has had earnings in some years and substantial losses in others, has never paid a dividend, and is widely reported in investment advisory services as seriously undercapitalized. Corporation Z has been in business a short period of time and manufactures a product that is new, is not sold by others, and must compete with a well-established alternative product that serves the same purpose. Z's stock is classified as a high-risk investment by most investment advisory services with the possibility of substantial long-term appreciation but with little prospect of a current return. A has studied the records of the three corporations and knows the foregoing facts. In each case the price per share of common stock purchased by B is favorable to B.

Under the standards of Reg. 53.4944-1(a)(2)(i), the investment of \$10,000 in the common stock of Y and the investment of \$8,000 in the common stock of Z may be classified as jeopardizing investments, while the investment of \$5,000 in the common stock of X will not be so classified.

Example 2:

Assume the facts of Example 1, except that in the case of: (a) corporation Y, B's investment will be made for new stock to be issued by Y; and there is reason to anticipate that B's investment, together with investments required by B to be made concurrently with its own, will satisfy the capital needs of corporation Y and will thereby overcome the difficulties that have resulted in Y's uneven earnings record; and (b) corporation Z, the management has a demonstrated capacity for getting new businesses started successfully and Z has received substantial orders for its new product. Under the standards of Reg. 53.4944-1(a)(2)(i), neither the investment in Y nor the investment in Z will be classified as a jeopardizing investment.

Example 3:

D is a foundation manager of E, a private foundation with assets of \$200,000. D was hired by E to manage E's investments after a careful review of D's training, experience, and record in the field of investment management and advice indicated to E that D was well qualified to provide professional investment advice in the management of E's investment assets. D, after careful research into how best to diversify E's investments, in order to provide for E's long-term financial needs, and to protect E against the effects of long-term inflation, decided to allocate a portion of E's investment assets to unimproved real estate in selected areas of the country where population patterns and economic factors strongly indicate continuing growth at a rapid rate. D determines that the short-term financial needs of E can be met through E's other investments. Under the standards of Reg. 53.4944-1(a)(2)(i), the investment of a portion of E's investment assets in unimproved real estate will not be classified as a jeopardizing investment. See Reg. 53.4944-1(c).

Example 4:

A private foundation received a donation of a whole-life insurance policy. At the time of the donation, the policy was subject to a policy loan that the insurer had made to the donor. The policy provided that, upon the death of the insured, the foundation would receive insurance proceeds in an amount equal to the face value of the policy reduced by the sum of the outstanding principal of the loans and any unpaid interest thereon. At the time the policy was donated, the life expectancy of the insured donor was 10 years. Instead of immediately surrendering the policy to the insurer for its cash surrender value, the foundation retained the policy as an investment and annually pays the premiums and interest due on the policy and the policy loan, respectively. The combined premium and interest payments are of such an amount that, by the end of eight years, the foundation will have invested a greater amount in premiums and interest than it could receive as a return on this investment, i.e., in the form of insurance proceeds upon the death of the insured. Thus, the insurance policy will produce a financial loss to the foundation at the end of eight years. Under the facts and circumstances, the foundation managers, by investing at the projected rate of return prevailing at the time of the investment, failed to exercise ordinary business care and prudence in providing for the long-term and short-term financial needs of the foundation in carrying out its exempt purposes. Thus, each payment made by the private foundation for a premium on the insurance policy and the interest on the policy loan is a jeopardizing investment. See Rev. Rul. 80-133, 1980-1 C.B. 258.

Example 5:

The manager of a private foundation invested the entire corpus of the foundation in a foreign bank without inquiring into the integrity of the banks. The manager did not know that the bank's license to do business and its charter had been revoked. Interest payments received by the foundation were irregular. The Tax Court agreed with the I.R.S. that the investment was a jeopardizing investment. See Thorne v. Commissioner, 99 T.C. 67 (1992). See IRM 7.27.18.6.2.2 for a discussion of advice of legal or qualified investment counsel; and IRM 7.27.18.6.2.6 for additional examples of the application of first-tier taxes.

Appendix B

Program-Related Investments by Asset Class, as
Approved by Private Letter Rulings

Loan Investments:

200331006: loan to housing development held PRI

200331007: loan to housing development held PRI

200331005: loan to housing development held PRI

200331008: loan to housing development held PRI

200034037: loan to help open media in formerly closed societies held PRI

199943058: loans to foreign government for economic development and loans to induce businesses to operate in country held PRI

9608039: loan to for-profit corporation for finding cure for disease held PRI

9551005: loans to media in formerly closed societies held held PRI

9434031: loans to exempt organizations serving needs of handicapped children held held PRI

9148052: loan to partnership to redevelop property for apartments in blighted area of city for elderly/low-income held PRI

9134031: loan to holding company that owns bank that serves minorities held PRI

9134030: same as 9134031

9112013: loan to partnership for housing project for low income in blighted area held PRI

9016078: loan to community organization for low-income housing held PRI

8943022: loan to pooled-risk fund to provide liability insurance to member agencies (tax-exempt organizations) held PRI

8923071: loan to partnership for low-income housing held PRI

8923070: loan for residential/commercial units in blighted area held PRI

8910027: loan to exempt organization to provide housing loans held PRI

8832058: loans to low-income young married couples for housing held PRI

8821087: purchase of bonds in exempt organization to provide interest-free mortgage loans to persons in area that have no more than 60 percent of median family income held PRI

8810026: loan to insurance fund that covers member tax-exempt organizations held PRI

8733043: loans to private colleges held PRI

8728053: loan to construct/equip research center for benefit of U.S. government held PRI

8708067: loan to exempt organization to create endowment in connection with research center re: environment/use of global resources held PRI

8547084: deposits to loan program managed by for-profit company that provides housing loans to low-income persons and financing to nonprofit developers of low-income housing held PRI

8445097: loans to exempt organizations to meet communication needs of exempt organizations held PRI

8445096: same as 8445097

8430082: loan for urban redevelopment and residential units to partnership held PRI

8429069: loan to exempt organization to renovate school held PRI

8426066: grants/loans to mature, indigent artists held PRI

8313105: loans/grants for historical preservation held PRI

8313104: same as 8313105

8313103: same as 8313105

8310090: loan to revolving fund to help cash-flow of charities held PRI

8301110: loan to partnership to construct hotel in blighted area held PRI

8242068: loan to partnership to construct hotel in blighted area held PRI

8234056: loans to charities held PRI

8225073: loan to partnership to construct hotel in blighted area held held PRI

8223046: same as 8225073

8221052: same as 8225073

8220060: same as 8225073

8245001: same as 8225073

8209027: loans to exempt organizations held PRI

8141025: loan to fund that provides financing to rehabilitate certain properties that serve the public interest held PRI

8139068: loan to exempt organization to combat community deterioration held PRI

8136080: loan to partnership to construct hotel in blighted area held PRI

8126092: grants/loans to indigent persons for necessities held PRI

8121167: loan to organization for preservation of landmarks held PRI

8030079: loan to entity for public redevelopment purposes held PRI

8025068: loan to help finance construction of family health center held PRI

Credit Enhancement

200043050: loan guaranty and interest rate subsidy to assist with financing of child-care facilities held PRI

9148049: private foundation's guaranty of bonds for purposes of downtown rehabilitation held PRI

9852023: obligation to indemnify or fund and pay malpractice and other liabilities prior to merger of medical centers held PRI

8105112: redevelopment program in city by assisting private developers to obtain financing to rehabilitate property; private foundation would provide indemnification/security on loans held PRI

Equity Investments:

200610020: equity in fund that invested in business in low-income communities held PRI
200343028: equity investment in farm management that focused on advanced agricultural methods and demonstration of methods held PRI
200343027: same as 200343028
200246036: equity in construction of buildings on area to be rented to church held PRI
200148078: acquisition of stock in intermediary between private foundation and pharmaceutical industry held PRI
200136026: equity investment in for-profit entity to finance environmentally oriented businesses (venture capital) held PRI
199950039: contribution by foundation to an LLC to perform services (operation/maintenance) in connection to lands that had environmental/conservation value and leased by foundation held PRI
199943044: acquisition of stock in company, which capital in turn would be used to encourage creation of jobs and economic development held PRI
199910066: equity investment in partnership to create/support new businesses, including high-tech ventures, held PRI
9834033: acquisition of interest in LLC for family support center purposes held PRI
9826048: financial and technical services by private foundation to businesses in areas of world economically deprived held PRI
9537035: equity contribution to community foundation for acquisition of stock in Major League Baseball club held PRI
9530025: same as 95337035
9449022: equity in museum held PRI
9111035: acquisition of stock in company that provides education experiences to children held PRI
9014063: equity in fund that will assist media hit by terrorism held PRI
8807048: purchase of holding in entity that makes investments in business mainly in depressed areas and for economic development held PRI
8710076: equity investment in exempt organization to purchase limited partnership interest (with focus on privatization of human services) held PRI
8704046: equity in structures surrounding museum for purposes of repair after storm damage held PRI
8628080: equity in reserve, which contains arboretum, and construction of visitors center held PRI
8549039: purchase of stock in for-profit company for purpose of economic development held PRI

8526084: purchase of stock in small business investment corporation (SBIC) for economic development held PRI
8332072: museum/land devised by will; equity investment in building structures on land held PRI
8101009: investment in subsidiary that will plan, develop, and manage housing and social welfare services in a national energy demonstration project that focuses on maximum conservation of energy with a low-income housing component (20 percent of units) held PRI
7813108: purchase of stock in bank that serves minority businesses that cannot obtain funding through traditional sources held PRI

Real Estate Investments:

199906053: acquisition of city block for rejuvenation purposes and use by public held PRI
199933051: proposed acquisition of land and construction of buildings for use by church held PRI
9426044: acquire and maintain land that is ecologically significant held PRI
9226073: acquire property that has retreat, retirement home, Alzheimer's treatment center and will be leased to exempt organization held PRI
9033063: purchase of land and construction of museum held PRI
8906062: lease land with cattle to exempt organization for research held PRI
8842067: ownership and operation of ecological area run like state park held PRI
8832074: purchase of land for conservation purposes held PRI
8803060: purchase of building to use as HQ and lease space to other exempt organizations held PRI
8531031: repair of storm damage to museum/area held PRI
8216087: purchase structure to be used as HQ and rented space to other exempt orgs held PRI
8150053: same as 8150052
8150052: purchase of island for purpose of conservation activities held PRI
8144060: same as 8150052, 815053
8110049: construction of build-outs on art gallery/library held PRI
7842052: creation of outdoor sculpture park held PRI
7823072: equity investment in large housing project for mixed population held PRI
7804107: construction of school buildings that would later be bought by school held PRI

Appendix C

Program-Related Investment Examples under
Treas. Reg. § 53.4944-3(b)

Treas. Reg. § 53.4944-3(b): Examples

Example 1:

X is a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling or unable to provide funds to X on terms it considers economically feasible. Y, a private foundation, makes a loan to X bearing interest below the market rate for commercial loans of comparable risk. Y's primary purpose for making the loan is to encourage the economic development of such minority groups. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment even though Y may earn income from the investment in an amount comparable to or higher than earnings from conventional portfolio investments.

Example 2:

Assume the facts as stated in Example 1, except that after the date of execution of the loan Y extends the due date of the loan. The extension is granted in order to permit X to achieve greater financial stability before it is required to repay the loan. Since the change in the terms of the loan is made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property, the loan shall continue to qualify as a program-related investment.

Example 3:

X is a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. Conventional sources of funds are unwilling to provide funds to X at reasonable interest rates unless it increases the amount of its equity capital. Consequently, Y, a private foundation, purchases shares of X's common stock. Y's primary purpose in purchasing the stock is to encourage the economic development of such minority group, and no significant purpose involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the purchase of the common stock is a program-related investment, even though Y may realize a profit if X is successful and the common stock appreciates in value.

Example 4:

X is a business enterprise which is not owned by low-income persons or minority group members, but the continued operation of X is important to the economic well-being of a deteriorated urban area because X employs a substantial number of low-income persons from such an area. Conventional sources of funds are unwilling or unable to provide funds to X at reasonable interest rates. Y, a private foundation, makes a loan to X at an interest rate below the market rate for commercial loans of comparable risk. The loan is made pursuant to a program run by Y to assist low-income persons by providing increased economic opportunities and to prevent community deterioration. No significant purpose of the loan involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 5:

X is a business enterprise which is financially secure and the stock of which is listed and traded on a national exchange. Y, a private foundation, makes a loan to X at an interest rate below the market rate in order to

induce X to establish a new plant in a deteriorated urban area which, because of the high risks involved, X would be unwilling to establish absent such inducement. The loan is made pursuant to a program run by Y to enhance the economic development of the area by, for example, providing employment opportunities for low-income persons at the new plant, and no significant purpose involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, even though X is large and established, the investment is program-related.

Example 6:

X is a business enterprise which is owned by a nonprofit community development corporation. When fully operational, X will market agricultural products, thereby providing a marketing outlet for low-income farmers in a depressed rural area. Y, a private foundation, makes a loan to X bearing interest at a rate less than the rate charged by financial institutions which have agreed to lend funds to X if Y makes the loan. The loan is made pursuant to a program run by Y to encourage economic redevelopment of depressed areas, and no significant purpose involves the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 7:

X, a private foundation, invests \$100,000 in the common stock of corporation M. The dividends received from such investment are later applied by X in furtherance of its exempt purposes. Although there is a relationship between the return on the investment and the accomplishment of X's exempt activities, there is no relationship between the investment per se and such accomplishment. Therefore, the investment cannot be considered as made primarily to accomplish one or more of the purposes described in 170(c)(2)(B) and cannot qualify as program-related.

Example 8:

S, a private foundation, makes an investment in T, a business corporation, which qualifies as a program-related investment under § 4944(c) at the time that it is made. All of T's voting stock is owned by S. T experiences financial and management problems which, in the judgment of the foundation, require changes in management, in financial structure or in the form of the investment. The following three methods of resolving the problems appear feasible to S, but each of the three methods would result in reduction of the exempt purposes for which the program-related investment was initially made:

- (a) Sale of stock or assets.** The foundation sells its stock to an unrelated person. Payment is made in part at the time of sale; the balance is payable over an extended term of years with interest on the amount outstanding. The foundation receives a purchase-money mortgage.
- (b) Lease.** The corporation leases its assets for a term of years to an unrelated person, with an option in the lessee to buy the assets. If the option is exercised, the terms of payment are to be similar to those described in (a) of this example.
- (c) Management contract.** The corporation enters into a management contract that gives broad operating authority to one or more unrelated persons for a term of years. The foundation and the unrelated persons are obligated to contribute toward working capital requirements. The unrelated persons will be compensated by a fixed fee or a share of profits, and they will receive an option to buy the stock held by S or the assets of the corporation. If the option is exercised, the terms of payment are to be similar to those described in (a) of this example.

Each of the three methods involves a change in the form or terms of a program-related investment for the prudent protection of the foundation's investment. Thus, under § 53.4944-3(a)(3)(i), none of the three transactions (nor any debt instruments or other obligations held by S as a result of engaging in one of these transactions) would cause the investment to cease to qualify as program-related.

Example 9:

X is a socially and economically disadvantaged individual. Y, a private foundation, makes an interest-free loan to X for the primary purpose of enabling X to attend college. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the loan and Y's exempt activities. Accordingly, the loan is a program-related investment.

Example 10:

Y, a private foundation, makes a high-risk investment in low-income housing, the indebtedness with respect to which is insured by the Federal Housing Administration. Y's primary purpose in making the investment is to finance the purchase, rehabilitation, and construction of housing for low-income persons. The investment has no significant purpose involving the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y's exempt activities and would not have been made but for such relationship between the investment and Y's exempt activities. Accordingly, the investment is program-related.

Under the standards of Reg. 53.4944-1(a)(2)(i), the investment of \$10,000 in the common stock of Y and the investment of \$8,000 in the common stock of Z may be classified as jeopardizing investments, while the investment of \$5,000 in the common stock of X will not be so classified.

Appendix D

Proposed Program-Related Investment Examples
Submitted by the American Bar Association Section
on Taxation

ABA SECTION ON TAXATION DRAFT EXAMPLES OF PROGRAM-RELATED INVESTMENTS (“PRIs”) (FOR ADDITION TO TREAS. REG. § 53.4944-3(b)) AND ANALYSIS OF EACH

Example 1:

Development of New Drug

C is a major, publicly traded pharmaceutical company with a substantial research and development budget. P is a private foundation whose exempt purposes include improving public health worldwide. P has consulted experts who have advised P that, with enough financial support, a drug (D) might be developed within 10 years to effectively treat a debilitating disease affecting millions of people in poor third-world countries. C does not have a research program directed at developing drug D, and P has concluded that commercial drug companies like C are unlikely to devote the resources required because the potential market for drug D is not as certain or as immediately profitable as others C can pursue. If drug D can be successfully developed and marketed, it could substantially improve public health in the affected countries as well as producing a very large profit for C. P has agreed to provide a loan to C at a below-market rate of interest, if C will devote the loan and a stated percentage of its own research and development funds to developing drug D over the next 10 years, and agrees to either manufacture and market or license drug D if developed in that time. C would not be willing to engage in such research activities absent P’s loan. P’s primary purpose in making the loan is to increase the likelihood and speed of development and marketing of drug D, in order to improve public health. The loan has no significant purpose involving the production of income or the appreciation of property. The loan significantly furthers P’s exempt purpose and would not have been made but for the relationship between the loan and that exempt purpose. The loan is a program-related investment.

Analysis: The possibility that the pharmaceutical company (C) might make a profit on the sale of the new drug (D) to be developed is secondary; this hasn’t been seen as a problem since Plumstead Theatre Society v. Comm’r, 74 T.C. 1324 (1980), aff’d, 675 F.2d 244 (9th Cir. 1982). But for P’s below-market-rate loan, C would not do the research

and development necessary to bring D to the market. P's purpose in making the loan is to facilitate the development and marketing of D, which will likely substantially improve the health of millions of people in poor third-world countries. While it is clear that if an activity is charitable when conducted in the U.S., it is likewise charitable if conducted in a foreign country, none of the existing Examples make this point.

Example 2:

Development of New Drug

Assume the facts as stated in Example 1, except that instead of a loan, C wants P to take an equity position in C in exchange for C's commitment to work on drug D. C has not been able to secure any venture capitalist investors because of the high risk involved in developing a new drug. Although, if successful, P's equity holding in C is likely to increase in value greatly, the investment has no significant purpose involving the production of income or appreciation of property. The investment significantly furthers P's exempt purpose and would not have been made but for the relationship between the loan and that exempt purpose. P's investment in shares of C is a program-related investment.

Analysis: This proposed Example ties together an equity investment in a for-profit company — which is already a permitted form of PRI, even though there is a possibility of a large return — with accomplishing a charitable purpose in a foreign country, which is also clearly permitted. None of the existing Examples in the Treasury Regulations contain both features.

Example 3:

Development of New Drug

Assume the facts as stated in Example 1, except that drug D has already been developed and tested, and is now ready to bring to market. However, due to cash constraints, C is currently unwilling to incur the substantial expenditures required to market, manufacture, and distribute drug D and train health-care providers in its use unless P agrees to make the loan. The loan significantly furthers P's exempt purpose and would not have been

made but for the relationship between the loan and that exempt purpose. The loan has no significant purpose involving the production of income or appreciation of property. P's loan is a program-related investment. *Analysis: The same as Example 1. C does not have the capital to bring the drug to market. P's below-market-rate loan will provide funds necessary for P to manufacture, market, and distribute drug D, and train health-care providers in its use, thereby benefiting potentially millions of persons in poor third-world countries. The fact that C will make a profit on the manufacture and sale of D is secondary to the accomplishment of a clear charitable purpose. Although this hasn't been a problem since the Plumstead Theatre case, the point still should be made clear.*

Example 4:

Development of New Organic-Farming Process

C is a start-up company that has been actively seeking venture capital financing, so far unsuccessfully. C's "product" is a new process that would greatly reduce the losses of certain crops to pests without the use of pesticides, thereby making organic farming of such crops cheaper, more profitable, and more widespread. P is a private foundation whose exempt purposes include fostering and promoting a cleaner environment. P has concluded that if C's process is widely adopted, it will result in greater use of organic farming and a substantial reduction in the world's total pesticide burden. C has approached P to invest in shares of C. As with all venture-capital investments, the risk of loss is extremely high, but, if successful, potential returns on investment are also extremely high. C has obtained commitments from several venture-capitalist investors, but not enough to move forward. C is offering shares to P on terms less favorable than those offered to the venture-capitalist investors. P's purpose in investing in C is to allow C to successfully market its new process, causing it to be widely adopted, and thereby reducing pesticide use, resulting in a cleaner environment. The investment significantly furthers P's exempt purposes and would not have been made but for the relationship between the loan and that exempt purpose. The investment has no significant purpose involving the production of income or the appreciation of property, although if C is successful, the value of P's shares could increase significantly. P's equity investment in C is a program-related investment.

Analysis: The possibility that the company (C), other investors, or P might make a substantial amount of money if the new “product” is successful is secondary; this has been clear since the Plumstead Theatre case. But for P’s investment the new “product” would not be developed and made available. C does not have the capital to bring the new “product” to market. P’s purpose in investing in C is to allow the development of an organic farming process whose use will result in significant environmental benefits, not financial returns. While there are Revenue Rulings, Private Letter Rulings, cases and federal legislation favoring efforts to preserve and protect the environment, none of the existing Examples in the Treasury Regulations address this important charitable endeavor.

Note that P is putting in the last dollars, which were otherwise unavailable. Query whether or not it would be permissible in such a situation for P to invest on the same terms as the for-profit investors?

Example 5:

Loan with Equity Kicker

Assume the facts as stated in Example 4, except that P’s investment will take the form of a loan with a below-market interest rate, and C has also offered P pre-initial public offering shares in C as an inducement to make the loan. If C is unsuccessful, the shares will be worthless, but if successful, the value of the shares could increase enough so that P would receive an extremely high rate of return on its investment. C has made the same offer to a series of venture capitalist investors, but was unable to obtain financing on these terms. P’s loan to C, and investment in shares of C, are both program-related investments.

Analysis: The addition of pre-IPO shares to P’s potential return should not have any effect on the loan and equity investment qualifying as a PRI. The existing Treasury Regulations provide generally that the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or appreciation of property. This Example provides a look at some of the “other factors” to be considered. The existing Treasury Regulations further provide that it is relevant whether the hypothetical investor solely engaged in investment for profit would be

likely to make the investment on the same terms as the private foundation. In this Example, it was clear that venture capitalists would not make the same investment on the same terms. This is a second reason why the inclusion of an equity “kicker” should not prevent the investment from being a PRI.

Example 6:

(Based on Priv. Ltr. Rul. 95-51-005 (Sept. 15, 1995), Priv. Ltr. Rul. 90-14-063 (Jan. 10, 1990) (grant/loan) and Rev. Rul. 74-587, 1974-2 C.B. 162)

Loans to Media in Former Communist Block Countries

X is a newspaper, Y is a television station, and Z is a radio station, all located in former communist block countries. In those countries, there is no effective banking system and the rates of return demanded by non-bank lenders are not financially feasible for the borrowers. P is a private foundation whose exempt purposes include promoting the development of independent, non-governmental, non-partisan, tolerant, and non-extremist media in countries that have historically been “closed” (or non-democratic). P makes loans to X, Y, and Z, on terms more favorable than would be available (if at all) from local commercial lenders, to promote independent, fair, honest, and responsible media in those countries. The loans significantly further the accomplishment of P’s exempt activities and would not have been made but for such relationship between the loans and P’s exempt activities. The loans have no significant purpose involving the production of income or appreciation of property. Although X, Y, and Z are for-profit businesses, they are merely the instruments by which P seeks to accomplish its exempt purposes. Accordingly, the investment is a program-related investment.

Analysis: First, this Example addresses development of “free” news media in former communist block countries. This is a clear charitable purpose, and was the subject of a Private Letter Ruling. Second, the investment is being made outside of the U.S., which, as discussed above, should not change the analysis. Third, the loans are being made to for-profit entities. The existing Treasury Regulations (Treas. Reg. § 53.4944-3(a)(2)(i)) already provide that the “purposes described in 170(c)(2)(B)” shall be treated as including such purposes irrespective of whether or not they are

actually carried out by organizations described in 170(c). The “merely the instruments” language from Rev. Rul. 74-587 is clearer. Inclusion of that language in one or more new Examples would be helpful. Lastly, P is making the loans in countries where there is no effective banking system or where the rates of return demanded are not financially feasible, and on more favorable terms than otherwise available, if at all. There is no profit motive, only a charitable purpose being served.

Example 7:

Based on Priv. Ltr. Rul. 1999-10-066 (Dec. 15, 1998)

Investment in LLC

B and C are private foundations, located in D, an economically depressed city. The exempt purposes of B and C include alleviating poverty, providing relief to the poor and distressed, and combating community deterioration. Both B and C make significant grants for economic development activity in D. B and C propose the formation of a Limited Liability Company (LLC X) with E, a for-profit entity well-experienced in technology transfer and business development. E will be the 51% owner and manager of LLC X. The purposes of LLC X will be to supplement and enhance technology transfer in D’s universities; assist in the creation of new technology businesses in D; help finance technology businesses that agree to locate their operations in economically depressed areas of D; and to encourage, support, and supplement the technology businesses by offering access to competent business advice and services. In addition, each of the technology businesses agrees to repay the investment in the event they leave D. If LLC X is unsuccessful, the investments by B and C will be worthless. The investments by B and C significantly further the accomplishment of their exempt activities and would not have been made but for such relationship between the investments and the exempt activities of B and C, respectively. No significant purpose of the investments is the production of income or the appreciation of property. Accordingly, the investments by B and C in LLC X are program-related investments even though B and C may both realize a substantial profit if LLC X is successful.

Analysis: None of the present Examples in the Treasury Regulations contemplate investments in LLCs. Although that form of business organization did not exist when the Regulations on PRIs were being written, it has become a commonly used investment vehicle and should be so recognized, and take its place along with corporations and limited partnerships. The I.R.S. issued a Private Letter Ruling on facts similar to these. There is the possibility that foundations B and C may both realize a substantial profit on their interests in LLC X if it is successful; but that is not the reason they made their investments. This Example illustrates that investments in 21st Century high technology are within the scope of 170(c)(2)(B), notwithstanding the antiquity of that , and may be made in the form of a PRI in appropriate circumstances.

Example 8:

Terrorist Attack

X, Y, and Z are small- to mid-sized for-profit business enterprises located in N, an urban area. On date S, a terrorist attack occurs in N, and results in significant damage to the business district of N where the offices of X, Y, and Z are located. The business operations of X, Y, and Z are affected because much of the infrastructure and many of the buildings in the business district have been damaged, and customers do not have easy access to the business district as a result of the attack. X, Y, and Z are having difficulty meeting the financial needs of their respective businesses. Conventional sources of funds are unwilling or unable to provide funds to X, Y, or Z on terms those businesses consider economically feasible. P is a private foundation whose exempt purposes include alleviating poverty, providing relief to the poor and distressed, and combating community deterioration. P makes loans to X, Y, and Z bearing rates of interest somewhat reflecting the credit risk of the businesses and circumstances, but financially acceptable to X, Y, and Z. P’s primary purpose for making such loans is to assist those businesses located in the business district of N affected by the terrorist attack. The loans significantly further the accomplishment of P’s exempt activities and would not have been made but for such relationship between the loan and P’s exempt activities. The loans made by P have no significant purpose involving the production of income or the appreciation of property. Accordingly, the loans to X, Y, and Z are all program-related investments.

Analysis: This Example addresses a traditional charitable purpose, namely, economic redevelopment of a physically “blighted” area, in starkly modern 21st Century clothes. The fact that the blight and accompanying economic distress were caused by the acts of terrorists, rather than urban decay, does not change the fact that their elimination serves a very traditional charitable purpose. While urban redevelopment is reflected in several Examples in the existing Treasury Regulations, it would be helpful to have a new Example should the need ever again arise and the private foundation community wanted to act quickly, without having to seek rulings. No further discussion is necessary with respect to either (a) no significant purpose of a below-market rate loan is the production of income or (b) the “instruments” through which the foundation seeks to accomplish its charitable purposes are not themselves tax-exempt entities.

Example 9:

National Disaster

Assume the same facts as stated in Example 8, but, instead of a terrorist attack, the damage to the business district in N was caused by a natural disaster (such as a hurricane, flood, earthquake or wildfire). P, a private foundation, makes loans to X, Y, and Z bearing rates of interest somewhat reflecting the credit risk of the business circumstances, but financially acceptable to X, Y, and Z. P’s primary purpose for making such loans is to assist those businesses located in the business district of N affected by the disaster. The loans significantly further the accomplishment of P’s exempt activities and would not have been made but for such relationship between the loan and P’s exempt activities. The loans made by P have no significant purpose involving the production of income or the appreciation of property. Accordingly, the loans to X, Y, and Z are all program-related investments.

Analysis: The same as Example 8, except that natural disasters are not new. Nonetheless, it would be helpful to have an Example covering a disaster. Perhaps it should address extensive damage to the business community caused by either a terrorist attack or a natural disaster.

Example 10:

(Based on Priv. Ltr. Rul. 2001-36-026 (June 11, 2001) and Rev. Rul. 74-587, 1974-2 C.B. 162)

Environmental Investments in Third-World Countries

F is a foreign, for-profit financial intermediary formed for the purpose of financing and promoting the expansion of environmentally oriented businesses that will contribute to conservation and economic development in areas of third-world countries that are economically or environmentally sensitive. F will make direct investments in businesses in third-world countries that involve the sustainable use of natural resources, foster the preservation of biological diversity, or engage in organic agriculture with biodiversity linkages. P, a private foundation which is a strong supporter of biodiversity and environmental sustainability, as well as development in economically undeveloped or underdeveloped countries or regions, makes a capital investment in F. The investment significantly furthers the accomplishment of P’s exempt activities and would not have been made but for such relationship between the investment and P’s exempt activities. The investment by P has no significant purpose involving the production of income or the appreciation of property. Although F is a for-profit business, it is merely the instrument by which P seeks to accomplish its exempt purposes. Accordingly, P’s investment is a program-related investment.

Analysis: Proposed Examples 10 and 11, based on a recent Private Letter Ruling, deal with environmental purposes and economic development in poor third-world countries, plus several important but heretofore ignored issues. In our world economy, it is important to be able to use foreign, for-profit financial intermediaries to accomplish 21st Century philanthropic goals. This is not much of a “stretch” from the non-tax-exempt entities, described in Rev. Rul. 74-587 which were “merely the instruments” by which the intended charitable purposes were accomplished.

Example 11:

Projected Rate of Return on Investment in Third-World Countries

Assume the facts as stated in Example 10 and that F has a goal of an 18% to 22% rate of return for its investors. Although seemingly high on its face for domestic investments, the projected rate of return is significantly less than the acceptable rate of return on international venture capital fund investments of comparable risk in third-world countries. The targeted rate of return, taken as a factor by itself by P, in a normal investment strategy (and not in conjunction with a program-related investment), would not compensate P for the speculative nature of the investment and overall risk associated with F's unique investment characteristics. The investment has no significant purpose involving the production of income or appreciation of property. Although F is a for-profit business, it is merely the instrument by which P seeks to accomplish its exempt purposes. Accordingly, the investment is a program-related investment even though P may earn income from the investment in an amount comparable to or higher than earnings from conventional domestic portfolio investments.

Analysis: Initially, the same as Example 10. In addition, this Example makes it clear that although the projected rate of return appears high on its face, it is, in fact, significantly less than an acceptable rate of return on international venture capital fund investments of comparable risk in third-world countries. This Example gives clear meaning to the provision in the existing Treasury Regulations that one has to look beyond the mere fact that the investment "produces significant income or capital appreciation" to the "presence or absence of other factors" to determine whether or not a significant purpose of the investment is the production of income or appreciation of property. Even with a projected return of 18% to 22%, the hypothetical investor solely engaged in investment for profit would not make this investment in a third-world financial intermediary. The rate was high, but not high enough. Therefore, P can make the investment as a PRI.

Example 12:

(Based on Priv. Ltr. Rul. 98-26-048 (Mar. 31, 1998) and Rev. Rul. 74-587, 1974-2 C.B. 162)

Economic Development in Depressed Countries

W and X are commercial banks, Y is a small agricultural business, and Z is a small manufacturing business, all located in countries that are economically depressed, largely because most commercial enterprises in those countries had in the past been controlled by the government. Businesses in those countries are either unable to obtain financing from local commercial sources or are unable to obtain such financing on economically feasible terms. P is a private foundation whose exempt purposes include alleviating poverty, providing relief to the poor and distressed, and combating community deterioration. P did the following (collectively, the "Foreign Investments"):

- (a) provided financial assistance to W, in the form of deposit insurance (to encourage deposits), and required W to make loans to local small businesses at below market interest rates and following standardized lending practices developed by P;
- (b) guaranteed a loan by X to Y; and
- (c) made an unsecured, below-market-rate loan to Z (or otherwise on less favorable terms than customarily required by commercial lenders or investors for profit).

The Foreign Investments all significantly further the accomplishment of P's exempt activities and would not have been made but for such relationship between the Foreign Investments and P's exempt activities. The Foreign Investments have no significant purpose involving the production of income or appreciation of property. Although W, X, Y, and Z are for-profit businesses, they are merely the instruments by which P seeks to accomplish its exempt purposes. Accordingly, all of the Foreign Investments constitute program-related investments.

Analysis: There is no question but that that if an activity is charitable when conducted in the United States, it is likewise charitable if conducted in a foreign country; that is not the main point to be made by this Example. Nor that loans to for-profit entities may be PRIs. One of the two significant features of this Example, which is based on a Private Letter Ruling, is that P is providing credit enhancement, not money, in two of the three Foreign Investments. The effect is the same, however; W is able to attract deposits from its customers, and Y is able to obtain a loan from X. Of no less importance, if P is ever called upon to make good on its deposit insurance or loan guaranty, those payments will constitute PRIs and, as such, will be considered “qualifying distributions.” The second significant feature of this Example is that the loan from P to company Z may not necessarily be at an interest rate which is “below market.” The interest rate may be at “market,” but some other term or terms of the loan will be below or not as attractive as those in loans made by commercial lenders or investors for profit under like circumstances.

Example 13:

(Based on Priv. Ltr. Rul. 1999-43-058 (Aug. 6, 1999), Priv. Ltr. Rul. 2000-36-050 (June 13, 2000, and Rev. Rul. 74-587, 1974-2 C.B. 162)

Foreign Economic Development

M is a poor country with a shortage of energy, natural resources, food and housing, and where local bank loans to businesses, if available, are at rates which are not economically feasible. W and X are commercial banks, and Y is a struggling small business, all located in M. Z is a financially secure business located elsewhere and unwilling to locate any operations in M without some financial inducements. P is a private foundation whose exempt purposes include alleviating poverty, providing relief to the poor and distressed, and combating community deterioration. P did the following (collectively, the “Foreign Investments”):

- (a) made a loan to the government of M at a below market rate, the terms of which required the money to be reloaned to W and X (who both joined in the loan agreement) at a below market rate, and that W and X reloan those proceeds to local small businesses at below market rates following standardized lending practices developed by P;

- (b) made a below-market-rate loan to Y (or otherwise on less-favorable terms than customarily required by commercial lenders or investors for profit); and
- (c) made a below-market-rate loan to Z (or otherwise on less-favorable terms than customarily required by commercial lenders or investors for profit) on the condition that Z locate operations in M.

The Foreign Investments all significantly further the accomplishment of P’s exempt activities and would not have been made but for such relationship between the Foreign Investments and P’s exempt activities. The Foreign Investments have no significant purpose involving the production of income or appreciation of property. Although W, X, Y, and Z are for-profit businesses, they are merely the instruments by which P seeks to accomplish its exempt purposes. Accordingly, all of the Foreign Investments constitute program-related investments.

Analysis: The below-market-rate loan to Y shows how an investment in a foreign for-profit business can accomplish a charitable purpose. The below-market-rate loan to the government of M, the proceeds of which must be reloaned to commercial banks in M, who must then reloan those proceeds at below-market rates following standardized lending practices developed by P, shows that there can be some considerable distance between the private foundation and the organization (the “instrument”) actually accomplishing the charitable purpose, while still qualifying as a PRI. The point of the below-market-rate loan to induce Z to locate operations in M is that a foundation is no longer limited to inducing companies to locate (and thereby provide jobs) in blighted inner-city neighborhoods in the United States, as envisioned by the Examples in the existing Treasury Regulations. Another significant feature of this Example is that the loans by P to companies Y and Z may not necessarily be at an interest rate which is “below market.” The interest rates may be at “market,” but some other term or terms of the loans will be below or not as attractive as those in loans made by commercial lenders or investors for profit under like circumstances.

Example 14:

(Based on Priv. Ltr. Rul. 83-011-10 (Oct. 8, 1982))

Rate of Return on Investment in Deteriorated Downtown

X is a limited partnership which will construct and own a large hotel in the presently blighted and deteriorated downtown area of Y. The land on which the hotel will be constructed is owned by the City of Y, which acquired it by eminent domain as part of a downtown redevelopment plan. Y will lease the land to X for 99 years. Long-term financing for the new hotel is being provided by a group of local banks, corporations and foundations. The foundations will receive interest on their loans at a rate considerably over the current “prime” rate and normal return on their portfolio investments, and the other lenders will receive the same rate plus a percentage of total room rentals over a set amount. P is a private foundation whose exempt purposes include alleviating poverty, providing relief to the poor and distressed, and combating community deterioration. P makes an investment in the form of a loan to X to help finance the new hotel, whose financial success is far from certain. The investment significantly furthers the accomplishment of P’s exempt activities and would not have been made but for such relationship between the investment and P’s exempt activities. The fact that P will receive a return on its investment which is considerably over the then-current “prime” rate and normal return on portfolio investments does not, by itself, necessarily indicate a profit motive; all factors must be considered. The investment has no significant purpose involving the production of income or appreciation of property. Accordingly, the investment is a program-related investment even though P may earn income from the investment at a rate considerably above that available from conventional portfolio investments by foundations.

Analysis: This Example, which is based on a Private Letter Ruling, illustrates a very traditional charitable endeavor, namely, revitalizing a deteriorated downtown area in a U.S. city. What is of particular interest is that the interest rate (15.0% in the actual Private Letter Ruling) was considerably over the then-current “prime” rate and normal return on foundations’ portfolio investments. This helps to show that even though the rate of return for a domestic investment may appear high on its face, “other factors” are relevant in determining whether a significant purpose of the investment is the production of income or appreciation of property.

Example 15:

(Based on Priv. Ltr. Rul. 90-33-063 (May 24, 1990) and Priv. Ltr. Rul. 2000-43-050 (July 25, 2000))

Credit Enhancement & Fees

X, a tax-exempt science museum, owns land on which it wants to construct a larger, more modern museum building, but does not have a sufficient credit rating to obtain long-term financing at an affordable rate. The specific use for which the new museum will be constructed reduces its value as collateral. P is a private foundation whose purposes include charitable, scientific and educational purposes. P makes the following investments:

- (a) P issues a letter of credit in favor of the bond trustee to guaranty payment of the first 20% of the principal amount of 20-year museum construction bonds to be issued by X and sold to investors, which bonds will be secured by the land and new museum building and bear a market interest rate; or
- (b) Instead of issuing a letter of credit, P purchases from its bank (and guarantees to the bank) a letter of credit in favor of an insurance company to guaranty payment of the first 20% of the principal amount of a 20-year mortgage loan to be made to the museum by the insurance company, which loan will be secured by the land and new museum building and bear a market interest rate; or
- (c) Instead of issuing or purchasing a letter of credit, P signs a guaranty of payment of the first 20% of the principal amount of a 20-year mortgage loan to be made to the museum by a commercial bank, which loan will be secured by the land and new museum building and bear a market interest rate.

In each instance, P receives from X an initial fee in the amount of 1.0% of the amount of the total borrowing, plus an additional annual fee of 1.0% of the loan amount outstanding from time to time.

In all three instances, the investments significantly further the accomplishment of P's exempt activities and would not have been made but for such relationship between the investments and P's exempt activities. The investments have no significant purpose involving the production of income or appreciation of property. Accordingly, the investments are all program-related investments.

Analysis: In the three scenarios in this Example (which combines two Private Letter Rulings) a foundation provides three different forms of credit enhancement to allow a science museum with a sagging credit rating to construct a larger, more modern building. In connection with the issuance of P's own L/C, P's purchase of an L/C from a local bank, and P's directly guarantying the museum's borrowing, P charged both initial and annual fees. Such fees, which are common in commercial lending and credit transactions, were approved in the two Private Letter Rulings cited. No significant purpose of any of the three forms of credit enhancement furnished by P involves the production of income or appreciation of property, and all three transactions constitute PRIs. Further, if P is ever called upon to fund its L/C or guaranty, or repay the bank if the bank's L/C is drawn upon, such payments by P will constitute qualifying distributions.

Example 16:

Equity Investment with Equity Kicker

X is a small business enterprise located in Z, a country that is economically depressed. Because X has generated little or no net income since its inception, conventional lenders are unwilling to provide funds to X at reasonable interest rates unless it increases the amount of its equity capital. Consequently, P, a private foundation, as well as two for-profit investors purchase shares of two new classes of X's common stock. P's exempt purposes include alleviating poverty, providing relief to the poor and distressed, and combating community deterioration. The two for-profit investors will be entitled to an annual dividend equal to 5% of X's net income, while P will be entitled to no such preferential annual dividend. However, to compensate P for the increased risk of holding an equity investment in X, P will be entitled to receive an "equity kicker" in the form of a special dividend (to be paid annually) in any year in which X's net income is in excess of a stated dollar amount. The dividend will

be 10% of that amount. P's primary purpose in purchasing the stock is to encourage economic development in Z, and no significant purpose involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of P's exempt activities and would not have been made but for such relationship between the investment and P's exempt activities. Accordingly, the purchase of X's common stock by P is a program-related investment, even though P may realize a sizeable profit if X is successful and (i) the common stock appreciates in value and (ii) P is entitled to a special dividend in any year.

Analysis: While this Example validates a foundation's investment in a foreign country to accomplish some traditional charitable purposes, such as economic development and providing new jobs, the main feature is the form of that investment. It is important to note that although P may receive something more than an ordinary investor would in an ordinary investment situation, namely, the "equity kicker," what P will receive is not the same as what the investors for profit are receiving. Presumably, those investors would not make their investment in X on the same terms as offered to P; they are getting the first 5.0% of X's annual profits, starting with the first dollar, as opposed to 10% over a stated level. This Example, too, shows that although P's investment may produce significant income or capital appreciation, that fact, in the absence of other factors, is not conclusive evidence of a significant profit motive.

Example 17:

Loan with Equity Kicker

The facts are the same as in Example 16, except that P makes a loan to X bearing interest below the market rate for commercial loans of comparable risk (or otherwise on less favorable terms than customarily required by commercial lenders or investors for profit). To induce P to make the loan to X, P will be entitled to receive an "equity kicker" in the form of the opportunity to purchase up to 100,000 shares of the common stock of X for \$.01 per share in the event that the stock of X is sold in an initial public offering. The loan significantly furthers the accomplishment of P's exempt activities and would not have been made but for such relationship between the investment and P's exempt activities. P's primary purpose

in making the loan is to encourage economic development in Z, and no significant purpose involves the production of income or the appreciation of property. Accordingly, the loan by P to X is a program-related investment, even though P may realize income from this investment in an amount higher than earnings from conventional portfolio investments due to the “equity kicker” feature of this investment.

Analysis: The same as in Example 16, except this one involves a loan (rather than a stock purchase) with an “equity kicker.” In both instances, P is getting something different (and less valuable) than what the company must offer to attract investors for profit. Even though the possibility exists for P to realize a sizeable return on its investment, P’s primary purpose in making the investment is to encourage economic development in Z and no “significant purpose” of the investment in either Example involves the production of income or appreciation of property. Another important feature of this Example is that the loan by P to X may not necessarily be at an interest rate which is “below market.” The interest rate may be at “market,” but some other term or terms of the loan will be below or not as attractive as those in loans made by commercial lenders or investors for profit under like circumstances.

Example 18:

(Based on Priv. Ltr. Rul. 2001-24-022 (Mar. 13, 2001)/public charity)

Lessening the Burdens of Government

The downtown area of the City of M is old and deteriorated; further, it is located next to the area’s most distressed low-income community. The City, together with its local community, civic and business leaders, wants to regenerate the downtown area into a center of commerce, housing, transportation, governmental services, cultural activities, and higher educational opportunities. The redevelopment will also result in the creation of many new jobs. As a result of existing renewal projects, there is a significant shortage of parking in the downtown area. The existing developments have both eliminated prior open-air parking lots and created

an ever-increasing demand for parking. A study commissioned by the City of M determined that there is a desperate need for substantially more parking in the downtown area, which will get worse as redevelopment continues and more employees, persons using municipal services and the courthouse, shoppers, diners, and visitors come to the downtown area.

Through its powers of eminent domain, the City of M acquired a large tract of land in the downtown area which is ideally suited for a parking garage. The City has agreed to lease the land to LLC X for development as a parking garage. LLC X is majority-owned and controlled by D, a for-profit real estate developer, who will operate and manage the new parking garage and receive a management fee. The other members of LLC X will include local businesses, community organizations and civic-minded investors. LLC X will borrow some of the necessary construction funds from a group of local banks, at market interest rates, and mortgage the improvements as security for the loan.

P is a private foundation whose exempt purposes include alleviating poverty, providing relief to the poor and distressed, combating community deterioration and lessening the burdens of government. P has agreed to loan the remainder of the necessary funds to the LLC at a below-market interest rate, without collateral (or otherwise on less favorable terms than customarily required by commercial lenders or investors for profit).

The provision of additional parking is essential to serve the needs of the stores, restaurants, municipal buildings, courthouse, and cultural and educational facilities being developed, as well as job creation, and, therefore, will “lessen the burdens of government” within the meaning of Treas. Reg. § 1.501(c)(3)-(1)(d)(2). P’s loan to LLC X has no significant purpose involving the production of income or appreciation of property. The loan significantly furthers P’s exempt purposes and would not have been made but for the relationship between the loan and those exempt purposes. P’s loan is a program-related investment.

Analysis: Urban renewal and economic redevelopment of physically blighted and economically depressed neighborhoods are very traditional charitable purposes and are already captured in the Examples contained in the existing Treasury Regulations. However, none of those Examples deal with such activities in terms of “lessening the burdens of government,” as did the Private Letter Ruling on which this situation is based. It would be helpful to have a new Example of a PRI made for that explicit purpose. Here, too, P’s loan to LLC X may not necessarily be at an interest rate which is “below market.” The interest rate may be at “market,” but some other term or terms of the loan will be below or not as attractive as those in loans made by commercial lenders or investors for profit under like circumstances.

Example 19:

(Based on Priv. Ltr. Rul. 2001-24-022 (Mar. 13, 2001)/public charity)

Single-Member LLC Owned by Foundation

The facts are the same as in Example 18, except that (a) foundation P is the sole owner and single member of LLC X, (b) the City of M sells the land for the parking garage to LLC X, (c) LLC X borrows 80% of the necessary construction funds from local banks at a market interest rate, with full recourse and secured by a mortgage on the land and new improvements, and (d) P invests an amount equal to the remaining 20% of the necessary construction funds in LLC X, from its own assets. Using LLC X to own and operate the parking garage insulates P’s charitable assets from potential judgments in favor of lenders, owners of damaged or stolen vehicles, or persons who might suffer injuries while on the garage premises.

The separate existence of single-member LLC X, which is wholly-owned and managed by P, will be disregarded for tax purposes. Even though funds for construction of the parking garage will be borrowed from local

banks, this will not result in P having any “debt-financed income.” Further, neither P’s ownership and management of LLC X nor LLC X’s ownership and management of the parking garage will result in P having any “excess business holdings.”

The provision of additional parking is essential to serve the needs of the stores, restaurants, municipal buildings, courthouse, and cultural and educational facilities being developed, as well as for job creation, and, therefore, will “lessen the burdens of government” within the meaning of 1.501(c)(3)-(1)(d)(2) of the Income Tax Regulations. P’s investment in LLC X has no significant purpose involving the production of income or appreciation of property. The investment significantly furthers P’s exempt purposes and would not have been made but for the relationship between the loan and those exempt purposes. P’s investment in LLC X is a program-related investment.

Analysis: In Example 19, the “burdens of government” are lessened through construction of a new parking garage in the city’s blighted downtown district by an LLC that is wholly owned by a private foundation. This raises many interesting and important 21st century issues, including disregarding the single-member LLC for tax purposes (and instead looking solely at P); the wholly owned LLC’s borrowing of funds to construct the parking garage not generating any “debt-financed income” for P; and the LLC’s 100% ownership of the parking garage not constituting an “excess business holding” by P. As private foundations move forward with more contemporary forms of grantmaking, and encounter more contemporary forms of doing business, these will be important considerations.

Appendix E

Case Study: California

I. Introduction

Private foundations in California are established either as nonprofit public benefit corporations under the California Corporation Code, or as charitable trusts under the California Probate Code.

Most California foundations are organized as nonprofit public benefit corporations, and as such are subject to the California Corporations Code,¹³⁵ and UMIFA, which is anticipated to be superseded by the enactment of UPMIFA in 2008. California foundations organized as nonprofit public benefit corporations must register and report to the Attorney General's Registry of Charitable Trusts. California law provides that donor intent will override the Corporations Code provisions governing the investment of charitable funds.¹³⁶

Foundations organized as charitable trusts must comply with the relevant sections of the California Probate Code,¹³⁷ and with UPIA.¹³⁸ The law requires a trustee to administer the trust in strict compliance with the trust instrument,¹³⁹ and UPIA specifically allows a settlor of a trust to set out terms of the trust that will expand on or restrict the prudent investor standard in the statute.¹⁴⁰ Trusts are required to be registered and reported upon to the Attorney General's Registry of Charitable Trusts as well.

The Attorney General's Charitable Trust Division has enforcement power to address a breach of trust, asset diversion, mismanagement of charitable assets, and fraud.¹⁴¹

¹³⁵ CAL. CORP. CODE §§ 5230-39 (governing the standard of conduct owed by directors to the corporation) and §§ 5240-41 (governing investment standards) are relevant to this discussion.

¹³⁶ CAL. CORP. CODE § 5240(c).

¹³⁷ CAL. PROB. CODE § 16002 (Trustee's Duties in General – Duty of Loyalty); § 16440 (Duty of Good Faith); & §§ 16100-16105 (Duties of Trustees of Private Foundations, Charitable Trusts) are most relevant.

¹³⁸ CAL. PROB. CODE §§ 16045-16054 and §§ 16002-16003.

¹³⁹ CAL. PROB. CODE § 16000.

¹⁴⁰ CAL. PROB. CODE § 16046(b).

¹⁴¹ CAL. CORP. CODE §§ 5250, 5223; GOV'T CODE §§ 12588, 12598. See also EDMUND G. BROWN, JR., AG, STATE OF CA., CALIFORNIA ATTORNEY GENERAL'S GUIDE FOR CHARITIES (2005), available at http://ag.ca.gov/charities/publications/guide_for_charities.pdf.

II. Uniform Prudent Management of Institutional Funds Act

The California legislature has recently adopted UPMIFA, and the bill will enter into law on January 1, 2009.¹⁴² The legislature adopted UPMIFA in its entirety, including the optional presumption of imprudence should annual spending exceed seven percent.

Given the status of the proposed legislation, no case law has yet been generated.

III. Uniform Management of Institutional Funds Act

UMIFA was enacted into law in California effective July 1, 1991, as part of the California Probate Code.¹⁴³ The uniform act was adopted in its entirety, without changes.¹⁴⁴ Prior to its adoption as part of the probate code, UMIFA applied only to educational institutions as part of the California Education Code.¹⁴⁵

The legislative history of UMIFA's introduction and enactment in California does not shed light on specific views held by California legislators of fiduciary responsibility, beyond the strictures set out by the uniform act itself.¹⁴⁶

No California cases directly cite to either the relevant sections of the California Probate Code¹⁴⁷ or to UMIFA.¹⁴⁸

IV. Uniform Prudent Investors Act

The California legislature enacted UPIA into law effective January 1, 1996, as part of the California Probate Code.¹⁴⁹ The California version of UPIA is the same in substance as the uniform version of the act.¹⁵⁰

The most significant provisions of the bill and a brief commentary addressing the new features that UPIA adds to trust law are set out in the legislative history to the California version of the uniform act.¹⁵¹ This commentary is consistent with the uniform act.

¹⁴² S.B. 1329. To check the status of the bill, see <http://www.leginfo.ca.gov> (follow "Bill Information" hyperlink) (last visited October 3, 2008).

¹⁴³ CAL. PROB. CODE §§ 18500-18509.

¹⁴⁴ S.B. 2649, 2008 Leg., 2007-2008 Reg. Sess. (Ca. 2008).

¹⁴⁵ CA S. B. 2649 extended its application to all religious and charitable organizations with endowment funds.

¹⁴⁶ See California Legislature, 2 Senate Final History 1121, 1727 (1989-1990 Regular Session), available at <http://192.234.213.35/clerkarchive> (click on "Histories/Indexes, then click on "1989").

¹⁴⁷ CAL. PROB. CODE § 18500.

¹⁴⁸ The one case that references UMIFA is *In re Matter of the Estate of Collins* 72 Cal. App. 3d 663, 669-72 (1977). This case was decided well before California adopted UMIFA, but references the Uniform Management of Institutional Funds Act, Civ. Code §§ 2290.1-2290.12, as support for the proposition that "the trustee is under a duty to the beneficiary to distribute the risk of loss by reasonable diversification of investments, unless under the circumstances it is not prudent to do so." The case held that defendant trustees failed to follow the prudent investor standard with respect to administration of testamentary trust where they invested two-thirds of trust principal in a single investment, which was real property secured only by a second deed of trust, and failed to make adequate investigation of either borrowers or collateral.

¹⁴⁹ CAL. PROB. CODE § 16045.

¹⁵⁰ The California legislation does depart from UPIA with respect to the reliance standard: California law adopts a "good faith" reliance standard under which a trustee shall not be held liable to a beneficiary for the trustee's good faith reliance on the express provisions of the trust instrument. CAL. PROB. CODE § 16046. By contrast, UPIA espouses a "reasonable" reliance standard.

¹⁵¹ S.B. 222 Senate Floor Bill Analysis describes the most significant provisions of the bill and provides brief commentary addressing the new features that UPIA adds to trust law at the time. See S.B. 222 B. An. (May 16, 1995), available at http://www.leginfo.ca.gov/pub/95-96/bill/sen/sb_0201-0250/sb_222_cfa_950516_152342_sen_floor.html.

With regard to risk and investment decisions, the Senate Judiciary Committee Bill Analysis notes, “Rather than avoiding risk categorically, the UPIA encourages balancing of risk and return at levels appropriate to the purposes of the trust.”¹⁵² This language may be interpreted to permit consideration for the charitable purpose of a charitable trust, and accordingly, an investment that advances that purpose may be permissible even if it delivered below-market returns – of course, subject as always to the overall portfolio strategy. As discussed above at I.B.4, UPIA lists appropriate circumstances to consider in investing and managing a trust’s assets. The purposes of the trust, as well as “an asset’s special relationship and special value, if any, to the purposes of the trust or to one or more of the beneficiaries” may weigh in an investment decision alongside expected returns.

The cases litigated under California Probate Code §16045 (UPIA) provide no specific guidance concerning mission investing by charitable trusts.¹⁵³ Case law under the statutorily mandated duty of loyalty is similarly silent on whether it is permissible for a charitable trust to consider the impact on mission of a foundation’s investments.¹⁵⁴

¹⁵² *Id.*

¹⁵³ The only case citing to CAL. PROB. CODE § 16045 that concerns the duty of care alleges the failure of a corporate trustee to oversee fiduciary accounts adequately. Investment decisions were not made for the accounts on an individualized basis, and excessive expenses were incurred. Ultimately, however, the case turned on an issue of hierarchy of federal over state laws, and held that the Securities Litigation Uniform Standards Act of 1998 preempts the state-law class claims. Thus, the judge dismissed all class claims, including the complaint under CAL. PROB. CODE § 16045. *Kutten v. Bank of America*, slip op. 2007 WL 2485001 (E.D.Mo. Aug 29, 2007).

¹⁵⁴ The reported cases under CAL. PROB. CODE § 16002 interpret aspects of the law other than investing per se, and most relate to personal, not charitable, trusts. See, e.g., *People v. Larkin*, 413 F. Supp. 978 (Cal. 1976) (a trustee who used trust assets as collateral to secure a loan for the trustee’s own for-profit company breached his fiduciary duty under CAL. PROB. CODE § 16002; it was of no consequence that the purported motive for obtaining the loan was the generation of profits that would be rechanneled into the trust); *Lynch v. Spilman* 67 Cal. 2d 251 (1967) (defining the nature of a charitable trust as “[a] charitable corporation] organized for the purpose, among other things, of promoting the welfare of mankind at large, or of a community, or of some class forming a part of it indefinite as to numbers and individuals”); *Allen v. Meyers*, 5 Cal. 2d 311 (Cal. 1936) (in dealing with the beneficiaries the trustee must show the utmost good faith; when the trustee sought to have the children of his deceased wife release him from their claims to real property, it was his duty to inform them of the money left by their mother on deposit in the bank, and the nature, character, and value any other property left by her as well as that deeded to him for their benefit).

V. Integration of California and Federal Tax Laws

California tax law is consistent with the federal tax law applicable to private foundations. Any changes to the private foundation rules of the I.R.C. would be incorporated into California law automatically.

The California Revenue and Taxation Code adopts the I.R.C.’s definition of “private foundation.”¹⁵⁵ California has not adopted its own provisions prohibiting jeopardizing investments or providing a program-related investment exception; rather, it has incorporated I.R.C. § 4944 by reference.¹⁵⁶ Any clarifications of this section by the I.R.S. would be incorporated into the California tax code as well.

VI. Practice Notes

No opinions published by the Attorney General address the prudence of investments made by public benefit corporations or trusts.¹⁶⁷ The lack of issued opinions and other guidance from the Attorney General’s office with respect to investments by charitable organizations indicates that investment decisions are unlikely to be scrutinized or second-guessed, unless a case of insider dealing, fraud, or excessive fees were to arise.

¹⁵⁵ CAL. REV. & TAX. CODE § 23709(a).

¹⁵⁶ “A private foundation shall not be exempt from taxation under § 23701(d) unless its governing instrument includes provisions the effects of which are ... (B) to prohibit the foundation from engaging in any act of self-dealing (as defined in § 4941 of the I.R.C.), from retaining any excess business holdings (as defined in § 4943 of the I.R.C.), from *making any investments in such manner as to subject the foundation to tax under § 4944 of the I.R.C.*” (emphasis added). CAL. REV. & TAX. CODE § 23708(e).

¹⁵⁷ For legal opinions of the California Attorney General, see <http://ag.ca.gov/opinions/>. Among those decisions reported concerning charitable organizations, none related to charitable trust or nonprofit investments. See Op. Ca. Att’y Gen. 04-502 (Mar. 28, 2005) (a city council member who serves of the board of a nonprofit trust may participate in a city council decision to lease a parcel of land to a business owner from whom the city council member solicited money on behalf of the nonprofit); Op. Ca. Att’y Gen. 96-301 (Feb. 7, 1997) (a member of a board of retirement established under the County Employees Retirement Law of 1937 may be removed from office for the willful breach of fiduciary duty or other malfeasance); Op. Ca. Att’y Gen. 95-807 (June 19, 1996) (concluding that “the treasurer of a general law county may grant to a contract investment manager, who is not a deputy of the treasurer, discretionary authority to invest funds on deposit with the treasurer, provided that the treasurer exercises prudence in the selection of the manager and imposes suitable safeguards to prevent abuse in the exercise of discretion by the manager. The treasurer would remain responsible for any investment decisions made by the manager”); Op. Ca. Att’y Gen. 95-105 (1995) (a public cemetery can use income from its endowment care fund to maintain roads located within the cemetery’s boundaries).

However, an inquiry by the Attorney General into a foundation's activities will not necessarily result in an enforcement action. If the foundation satisfies the Attorney General's office that its activities are legitimate, or if it takes actions to redress any illegitimate activity, the issue may never be reported publicly. Even in the case of an enforcement action, a public report — such as a judicial decision — may not be issued. As a result, the issuance of opinions does not fully reflect the priorities of an attorney general. On the whole, however, we conclude that California foundations have broad latitude under the law and in practice within which they may choose to engage in mission investing.

In a pioneering step, California has recognized that non-judicial decisions offer valuable guidance to charitable institutions, and is in the process of posting on its website summaries of non-judicial decisions by the office on a no-names basis.¹⁵⁸ Given the authority the Attorney General has over local charities, the additional transparency this information may provide promises to advance legal clarity for foundations seeking to interpret California fiduciary standards, as well as to provide practical guidance to foundations regarding the Attorney General's enforcement priorities.

Appendix F

Case Study: New York

¹⁵⁸ For the Charitable Trust Division generally, see <http://ag.ca.gov/charities/index.php> (last visited July 31, 2008). See also Columbia Law School Charities Project of the State Attorneys General, http://www.law.columbia.edu/center_program/ag/CharitiesProj, which seeks to provide a resource to attorneys general in fulfilling their enforcement responsibilities over charitable institutions.

I. Introduction

Private foundations organized under New York state law are controlled either by the state's Not-for-Profit Corporation Law or its Estates, Powers, and Trusts Law. If a New York private foundation is organized as a corporation, its investment authority is governed by the New York Management of Institutional Funds Act, an amplified version of UMIFA.¹⁵⁹ An overlying duty of obedience binding a charity's directors to the purposes and goals of the organization informs the law: "Unlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are [sic] central to the *raison d'être* of the organization."¹⁶⁰ A donor's intent will trump a provision of the statute, in the case of inconsistency.¹⁶¹

If a New York private foundation is organized as a trust, its investment authority is governed by the New York Prudent Investor Act.¹⁶² The statute articulates the duties of the modern trustee when investing institutional funds. As summarized by the sponsoring legislative committee:

[The modern prudent investor] looks for total return; he is not especially concerned about the difference between principal and income... he is investing both for current and long-term benefit. He sees the portfolio as a whole and diversifies investments to limit specific risks. He assesses the acceptable risk and seeks to maximize return at that risk level. He hires professional help where needed.¹⁶³

¹⁵⁹ N.Y. NOT-FOR-PROFIT CORP. LAW (hereinafter "NY NPCL") §§ 102(a) (definitions), 512 (granting broad investment authority to an organization's governing board), 513 (describing the administration of assets received for specific purposes), 514 (granting authority to delegate investment duties), 522 (providing less stringent standards for release of restrictions on use or investment of gifts), & 717 (setting the board's standard of care as that which "ordinarily prudent men would exercise under similar circumstances in like positions").

¹⁶⁰ *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S. 2d 575, 593 (N.Y. Sup. Ct. 1999).

¹⁶¹ NY NPCL § 513(b).

¹⁶² N.Y. EST. POWERS & TRUSTS LAW (hereinafter "NY EPTL") § 11-2.3.

¹⁶³ Proposed Prudent Investor Act in N.Y., EPTL-SCPA LEG. ADVISORY COMM., THIRD REPORT 16 (Mar. 22, 1993), available at <http://www.nysl.nysed.gov/scandoclinks/ocm31960368.htm>.

New York trust law imposes a duty of obedience on a trustee. Accordingly, a trustee must administer the trust strictly in compliance with the terms of the trust as set out by the settlor.

II. UPMIFA

UPMIFA has not been enacted in New York, nor has it been introduced to the legislature.¹⁶⁴ No public discussions have been held concerning its enactment, short of consideration by the Non-Profit Organizations Committee of the New York City Bar Association. That committee endorsed UPMIFA while suggesting the major change that UPMIFA apply only to new foundations, and not retroactively to existing ones.¹⁶⁵

III. UMIFA

UMIFA is incorporated into several provisions of N.Y. Not-for-Profit Corporation Law. In 1978, the legislature passed the "New York Management of Institutional Funds Act."¹⁶⁶ Directors and officers of nonprofit corporations must exercise "good faith and...that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions."¹⁶⁷ While it is the business judgment rule that applies to New York nonprofit corporations, the law relies on a prudence standard in elaborating on that rule.

Consistent with UMIFA, New York law requires that fiduciaries of an endowment fund maintain the historical dollar value of the assets.¹⁶⁸

¹⁶⁴ Uniform Law Commission, UPMIFA, *Enactment Status Map*, <http://www.upmifa.org/DesktopDefault.aspx?tabindex=5&tabid=68> (last visited September 21, 2008).

¹⁶⁵ Letter from David G. Samuels, Chair, N.Y.C. Bar Assoc., Committee on Non-Profit Orgs., to Mr. Hawkins, Drafting Committee of UPMIFA (Aug. 10, 2007), available at http://www.nycbar.org/pdf/report/Charitable_organizations.pdf.

¹⁶⁶ NY NPCL §§ 102, 513, & 717.

¹⁶⁷ NY NPCL § 717.

¹⁶⁸ NY NPCL §§ 513(c), 717.

IV. UPIA

UPIA is substantially included in New York's more comprehensive "Prudent Investor Act."¹⁶⁹ New York's legislation is intended to be "close in concept and spirit" to UPIA.¹⁷⁰ The Act was approved on July 26, 1994, and took effect January 1, 1995.¹⁷¹

The Act enunciates a prudent investor standard, which adopts modern portfolio theory, and requires a trustee to determine an overall portfolio strategy that is diversified and meets the short- and long-term needs of the trust's beneficiaries. A trustee must exercise reasonable care, skill and caution, and must take into account the purposes and terms and provisions of the governing instrument.¹⁷²

The case law applying the New York Management of Institutional Funds Act or the New York Prudent Investor Act to charitable organizations does not elaborate or expand upon those laws codifying the investment decision-making authority and responsibility of managers of charitable assets. Existing case law involves acts of gross negligence, nonfeasance, or

acts of bad faith such as fraud and self-dealing. Nothing in the case law suggests that a fiduciary would be held liable for an investment decision made in good faith and with the requisite degree of care.¹⁷³

V. Integration of New York and Federal Tax Laws

New York has practically identical provisions in its Not-For-Profit Corporation Law and its Estates, Powers and Trusts Law referring to private foundations.¹⁷⁴ These sections were enacted together in 1971 to ensure strict conformance of New York law with federal law, including I.R.C. § 4944.¹⁷⁵ Any change to the federal tax laws relating to private foundations would be incorporated automatically into New York state law. No New York case law or attorney general opinion elaborates on any of these requirements or specifically discusses jeopardy investing.¹⁷⁶

¹⁶⁹ NY EPTL § 11-2.3.

¹⁷⁰ EPTL-SCPA LEG. ADVISORY COMM., THIRD REPORT § IV at 43.

¹⁷¹ The Act was drafted and recommended by an Estate, Powers and Trusts Law ("EPTL") Advisory Committee created by joint resolution of the Senate and Assembly Judiciary Committees. The Act was drafted to incorporate basic principles of the Prudent Investor Rule from RESTATEMENT 3D, TRUSTS, a related Illinois statute (ILLPIA), and the Uniform Prudent Investor Act, which at the time was still a work in progress. The Committee's Third Report, released in March 1993, explains the Committee's reasoning in full. See Proposed Prudent Investor Act in N.Y., EPTL-SCPA LEG. ADVIS. COMM., THIRD REPORT (Mar. 22, 1993), available at <http://www.nysl.nysed.gov/scandoclinks/ocm31960368.htm>. The purpose of the new Prudent Investor Act was to replace the prior law of fiduciary investment (then codified as NY EPTL § 11-2.2(a) & (b)(1)) and the traditional prudent man rule. Proposed Prudent Investor Act in N.Y., EPTL-SCPA LEG. ADVIS. COMM., THIRD REPORT at 2, 15-16. The Act as a whole reflects "a major national trend in the law of fiduciary investment, in response to changing economic conditions, newer investment vehicles and strategies, modern investment theory and an evolving regulatory environment for fiduciaries." *Id.* at 2.

¹⁷² NY EPTL § 11.2.3(b).

¹⁷³ For example, in *In re Janes*, 90 N.Y.2d 41 (N.Y. 1997), the Court of Appeals found a corporate fiduciary liable for imprudently investing an estate's assets, part of which was bequeathed to charitable beneficiaries. In applying the Prudent Person Rule (the earlier, more stringent version of the modern Prudent Investor Rule), the Court makes clear that a fiduciary's conduct will not be judged by the success or failure of any one investment or of the trust overall, for mere error in investment judgment, or for failure to adhere strictly to any particular investment strategy. The correct focus is on the fiduciary's decision-making procedure; liability attaches when a fiduciary fails to exercise reasonable care, skill and caution. Here, liability was supported by proof that the fiduciary: (1) failed to conduct an initial formal analysis of the estate and establish an investment plan consistent with the testator's primary objectives; (2) failed to follow its own internal procedures during the administration of the estate; (3) failed to conduct more than routine reviews of the holdings at issue or consider alternative investment choices, despite a seven-year period of steady decline in the value of the stock; and (4) ultimately failed to diversify the estate's large concentration of stock, letting it drop to approximately one-third of its date-of-death value. The lower court's opinion contains a thorough explanation of the applicable test. *In re Janes*, 643 N.Y.S.2d 972, 976-977 (N.Y. App. Div. 1996) ("While mere erroneous judgment or poor investment performance cannot be the basis of a finding of imprudence, where the facts known at the time of the decision establish its unreasonableness, a finding of imprudence is warranted.")

In another example, *S.H. and Helen R. Scheuer Family Foundation, Inc. v. 61 Assocs.*, 582 N.Y.S.2d 662 (N.Y. App. Div. 1992), the Appellate Division, First Department, held that a cause of action under the Not-For-Profit Corporation Law was properly alleged by plaintiffs complaining that defendants imprudently and negligently invested a foundation's assets. Here, the complaint focused not on the results of the investment decisions but on the directors' decision-making procedures, alleging that defendant directors knowingly approved self-dealing investment acts, improperly withheld information from the other directors, and engaged in bribery and coercion in order to cover up such wrongdoing.

¹⁷⁴ NY NPCL § 406; NY EPTL § 8.18.

¹⁷⁵ See *In re Hammer*, 362 N.Y.S.2d 753, 759 (N.Y.Sur. 1974). See also NY EPTL § 8:8.1 commentary (McKinney 2002) (stating that the purpose of this section was to incorporate the restrictions imposed by the 1969 Tax Reform Act into current and future NY trusts), Memorandum of Joint Legislative Committee to Study Revision of Corporation Law on Private Foundations, Distribution of Taxable Income, NEW YORK LEGISLATIVE ANNUAL 136 (1971).

¹⁷⁶ See discussion *supra* Part I.B.7.e.

VI. Practice Notes

The New York State Attorney General's office is responsible for overseeing the administration of private foundations' charitable assets, representing the interests of beneficiaries of charitable dispositions, and enforcing the applicable governing law that includes the common law duties of care, loyalty, and obedience.¹⁷⁷ The Attorney General has broad statutory authority to prosecute and defend legal actions to protect the interests of New York and the public.¹⁷⁸

The New York Attorney General's Office has issued no formal or informal opinions that interpret the standards for the investment of foundation assets.¹⁷⁹ Concern for ensuring the diversification of charitable portfolios has been expressed by the AG, but short of self-dealing or fraud, the AG's office has not indicated an inclination to intervene in the management of charitable assets. We conclude from this that New York foundations in law and in practice have broad latitude to invest in accordance with their mission.

Appendix G

Case Study: Oregon

¹⁷⁷ N.Y.S. Atty Gen. Charities Bureau, THE REGULATORY ROLE OF THE ATTORNEY GENERAL'S CHARITIES BUREAU 3-4 (2003), available at <http://www.oag.state.ny.us/charities/role.pdf>.

¹⁷⁸ *Id.*

¹⁷⁹ For opinions issued by the New York Attorney General's Office, see <http://www.oag.state.ny.us/lawyers/opinions/indexsub.html> (last visited July 31, 2008).

I. Introduction

Private foundations in Oregon are established as either nonprofit corporations or as trusts, and are governed accordingly by either the Oregon Non-Profit Corporation Law¹⁸⁰ or Oregon trust law.¹⁸¹ Both bodies of law set out standards of care, loyalty and prudence incumbent upon a foundation's directors¹⁸² or trustees¹⁸³ in managing and investing assets. Oregon trust law, which is based on the Uniform Trust Code,¹⁸⁴ requires a trustee to administer a trust in accordance with the settlor's express intent.¹⁸⁵ The prudent investor rule as expressed in UPIA and adopted by the Oregon legislature states affirmatively that it is to be construed as a default rule that may be "expanded, restricted, eliminated or otherwise altered by the provisions of a trust."¹⁸⁶

II. UPMIFA

UPMIFA entered into force in Oregon on January 1, 2008,¹⁸⁷ and thereby repealed and replaced UMIFA.

The Oregon legislature chose to include the optional provision concerning a rebuttable presumption of imprudence should an endowment's payout exceed seven percent.¹⁸⁸ The Attorney General's Charitable Activities section successfully expressed its view that UPMIFA's shift away from

preserving the historic dollar value of a foundation's endowment in favor of preserving its purchasing power would be acceptable so long as a benchmark were established as a precaution. Otherwise, the uniform act was adopted without substantive alteration.¹⁸⁹

As discussed above, UPMIFA seeks to harmonize the standards of prudence, duty, and care incumbent on the management of all charitable funds, regardless of their corporate form. UPMIFA defers to donor intent, and as a result, careful drafting of a charitable organization's constitutive documents will overcome any provisions of the statute to which a donor does not wish her foundation to be subject.¹⁹⁰

III. UMIFA

UMIFA was enacted by the Oregon legislature in 1972 without material alteration from the uniform act.¹⁹¹ While it has been replaced and repealed by UPMIFA as of January 1, 2008, it provided guidance regarding the investment of Oregon endowment assets for almost thirty-six years. The key provisions concerning prudent investment, standard of duty and care applied in Oregon until UPMIFA entered into force. No cases were litigated in Oregon under UMIFA.

IV. Uniform Prudent Investor Act

UPIA was enacted in Oregon in 1995, and adopts the uniform act in its entirety.¹⁹² UPIA displaced the older "prudent man" standard, bringing Oregon trust law into line with modern investment practices by embracing a total portfolio approach, rather than determining the risk/return profile of individual investments.

¹⁸⁰ OR. REV. STAT. Ch. 65.

¹⁸¹ OR. REV. STAT. Ch. 130 (UNIFORM TRUST CODE).

¹⁸² OR. REV. STAT. § 65.357(1) (prescribing that a director shall discharge his or her duties in good faith, with the care an ordinarily prudent person in a like position would exercise in similar circumstances, and in a manner the director reasonably believes to be in the best interests of the corporation)(emphasis added).

¹⁸³ OR. REV. STAT. §§ 130.650-130.680.

¹⁸⁴ The UNIFORM TRUST CODE was adopted by the NCCUSL in August 2004 and was last revised or amended in 2005.

¹⁸⁵ OR. REV. STAT. § 130.650.

¹⁸⁶ OR. REV. STAT. § 130.750(2).

¹⁸⁷ H.B. 2905, 74th Leg. Ass., 2007 Reg. Sess. (Or. 2007), was signed by the governor on June 22, 2007 and chaptered No. 554 of July 11, 2007. The statute is set out at OR. REV. STAT. §§ 128.305-128.336.

¹⁸⁸ OR. REV. STAT. § 128.322(4)(b).

¹⁸⁹ Oregon includes funds managed or moneys held for investment by the state treasurer in the definition of "institutional funds" subject to the provisions of UPMIFA. OR. REV. STAT. § 128.316(5)(d). In addition, Oregon subjects gifts from private donors to a public body or any instrumentality of a public body to UPMIFAs reach. OR. REV. STAT. § 128.328(5).

¹⁹⁰ OR. REV. STAT. §§ 128.310-128.355 (repealed).

¹⁹¹ Oregon has limited case law in general, and the area of nonprofit corporations and charitable trusts is no exception.

¹⁹² OR. REV. STAT. §§ 130.750-775 (formerly OR. REV. STAT. §§ 128.192-128.218).

No legislative history or case law exists that would provide guidance or insight into the Oregon legislature's or judiciary's interpretation of UPIA.

V. Integration of Oregon and Federal Tax Laws

Oregon's Non-Profit Corporation Law provides that a nonprofit corporation that is deemed to be a private foundation under the definition of the I.R.C. shall be subject under Oregon law to the tax regulations of the I.R.C. applicable to private foundations.¹⁹³ This includes § 4944 containing the prohibition against jeopardizing investments and the exception for program-related investments.¹⁹⁴

Similarly, private foundations organized as trusts are subject to the Code's regulations, including the jeopardy investment prohibition and its program-related investment exception.¹⁹⁵

As a result, any changes made to the I.R.C. would be incorporated into Oregon law.

VI. Practice notes

The Attorney General's Charitable Activities section has not to date had significant enforcement actions regarding the investment activity of charitable organizations. No guidance from the Attorney General's Office interprets the relevant laws of investing the assets of a charitable organization, including a private foundation organized as a nonprofit corporation or a trust.¹⁹⁶

As in California and New York, we conclude that this indicates that Oregon foundations enjoy broad latitude both in law and practice to manage their investments in accordance with their charitable purposes.

¹⁹³ OR. REV. STAT. § 65.036.

¹⁹⁴ OR. REV. STAT. § 65.036(4).

¹⁹⁵ OR. REV. STAT. § 128.085.

¹⁹⁶ The Oregon Attorney General's opinions may be found at <http://www.doj.state.or.us/agoffice/>.

Appendix H

Sample Investment Policy Statement

I. Statement of Fiduciary Responsibility

We recognize that our fiduciary responsibility requires that we maximize return, minimize risk, and consider the impact of our investments on advancing the philanthropic goals of the foundation. Consistent with the Foundation’s mission to [SPECIFIC FOUNDATION’S MISSION] we seek, where possible, to invest our endowment assets in companies that [SPECIFIC GOALS] advance this mission, and we seek to avoid investing in companies that contribute to the very issues the foundation’s grantmaking seeks to address.

II. Spending and Investment Goals

In general, the Foundation seeks to generate income and capital gains necessary to support its operations and fund its grantmaking [over the long term/for a specified number of years if spending down endowment is desired], as follows:

- to provide capital directly to or own the equity or debt of enterprises that further the foundation’s mission
- to avoid investing in companies whose impacts contribute to the problems that the foundation’s grantmaking seeks to address
- to set spending levels based primarily on an assessment of current need and of current and projected investment returns
- [if perpetual endowment is desired: to preserve, to the extent possible consistent with the foundation’s spending levels, the real (inflation-adjusted) value of its assets over the long term].

Primary Return Objective and Risk Tolerance

The primary return objective is to maintain or increase the purchasing power of the Foundation’s portfolio in order to support future grant expenditures and related administrative expenses, with consideration for the consistency of the Foundation’s investments with its charitable goals. This objective can be met by earning an average annual total return of [] percent over the long term. This [] percent dollar-weighted total return defines the Fund’s required return. The target rate of return is also [] percent.

Primary Return Objective

REQUIRED RATE OF RETURN	PERCENT
Program Grants Program Administration Expenses Investment Management Expenses* Excise Taxes <i>Payout</i>	
Real Growth of Assets Reinvestment (adjustment) for Inflation <i>Required Arithmetic Return</i>	
<i>Volatility Adjustment (Monte-Carlo)</i>	
Total Required Rate of Return (ROR)	
<i>* Using an Index Strategy</i>	

Spending Policy (Payout)

At each year-end meeting the Board will set a target amount for grants to be made during the ensuing year. This Investment Policy Statement is based upon the Foundation’s current spending policy (and five-year trailing spending policy) set at approximately [at least 5] percent of the current value of the Foundation’s portfolio. Should the spending policy be permanently adjusted up or down, this Investment Policy Statement should be revised.

In order to achieve the primary return objective, the Board is comfortable with a risk level of the portfolio that is similar to the volatility (standard deviation) and drawdown characteristics of [the broad U.S. equity market (Wilshire 5000 index) at **100 percent**] of the volatility of such a market. “Risk” includes both the risk of not attaining the primary return objective over several years, as well as the risk of loss of capital.

The Board believes a well-diversified portfolio structured according to this Investment Policy Statement should meet or exceed the Foundation’s primary return objective over the long term, at an acceptable level of overall risk.

Given the Foundation's very low tax rate, there is no preference as between sources of income (capital gain or ordinary income), therefore, the Fund will utilize a total return approach in pursuing the objectives. In other words, the portfolio structure does not target a specific income level; rather the return objective is expected to be achieved through both capital appreciation and current income. Hence, the Foundation will meet the cash flow needs using either income or principal or both.

Investment Guidelines

The Foundation's assets will be managed by professional money managers that are selected by the Investment Committee. Assets are allocated in accordance with guidelines set forth by the Investment Committee and approved by the Board. Investment managers have discretion to manage the assets in each particular portfolio to best achieve investment objectives and requirements consistent with the social and financial guidelines set forth in the Foundation's Investment Policy Statement. Managers will be monitored on a quarterly basis.

Asset Allocation

Assets will be diversified both by asset class (domestic equities, foreign equities, fixed income, venture capital, private placements and real estate) and within each asset class.

Foreign debt and equity securities may include an allocation to emerging market countries. Emerging market securities are defined as those included in the MSCI EEM Index for equities, and the JPMorgan EMBI Index for bonds. The emerging market allocation may be accomplished via the hiring of managers specializing in emerging markets investing or through an allocation within broad foreign portfolios. Emerging market debt securities should not exceed [] percent of the market value of total foreign debt securities. Emerging market equity securities should not exceed [] percent of the market value of total emerging market equity securities.

Asset allocation will fall within the following ranges:

Equities: [percentage range]

- U.S. Large Cap
- U.S. Small Cap
- International
 - Developed Markets
 - Emerging Markets

Fixed Income: [percentage range]

- Domestic
- International
 - Developed Markets
 - Emerging Markets

Alternative Investments: [percentage range]

- Private equity
- Hedge funds
- Real estate
- Timber
- Other

Screening

The Foundation views its investments as an integrated component of its overall mission. Investments are based on sound, professional financial analysis and filtered through screens consistent with and in support of the Foundation's values and mission. Exclusionary screens guide managers on companies to avoid, and inclusionary screens guide managers on companies in which to invest.

Screening will be conducted as follows:

Exclusionary Screens:

[Tailored to individual foundation's programmatic interests]

Inclusionary Screens:

[Tailored to individual foundation's programmatic interests]

Proxy Voting Guidelines

The Foundation asks each of our managers, as well as our responsible investing service providers, to inform us of shareholder resolutions being considered with corporations in which we hold stock.

The Foundation votes its proxies as follows:

- When program interests are directly involved, proxies are voted in a manner consistent with them.
- When a shareholder resolution deals with a social or environmental issue that is not directly related to the Foundation’s program interests, the Foundation will review each individual case and consult with our grantees, managers and others, as appropriate.

Monitoring

The Investment Committee will monitor the performance of the Foundation’s managers on a quarterly basis.

Performance Standards

The benchmarks against which the Foundation’s long-term investment performance is measured are set out below. For total Foundation assets and for each asset class a peer group universe benchmark and market index benchmark has been established. It is expected that the aggregate fund and the individual managers will meet or exceed these performance standards on the following bases:

- Absolute returns should exceed both benchmarks on a three- and five-year rolling basis
- Risk, as measured by the annualized standard deviation of quarterly returns, should be less than that of the market index over the same three- and five-year rolling periods. Higher volatility is acceptable if the risk-adjusted return, as measured by the Sharpe ratio, is greater than that of the market index.

The peer group manager universe benchmarks are to be composed of professionally managed institutional managers for the Foundation’s separate and collective account managers and mutual funds for the Foundation’s mutual fund managers. The market index benchmarks were established in light of the Foundation’s financial objectives and long-term expectations for the capital markets and inflation.

Benchmarks

Asset	Peer Group Universe	Market Index
Total Foundation	Endowment/Foundation Universe	
Fixed Income		
Domestic Equity: Large Cap Small Cap		
International Equity		
Alternative Investments		

Manager Review and Termination

Investment funds may be placed on “watch” status, replaced or terminated whenever the Investment Committee loses confidence in the management of the fund, when the characteristics of the fund are no longer consistent with the fund’s intended role, or the current style is no longer deemed appropriate.

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Resources

New York University School of Law’s Center on Law and Philanthropy: Nonprofit Legal Guide (<http://www.law.nyu.edu/nclpl/library/bibliography.html>)

PRI Maker’s Network (<http://www.primakers.net>)

Social Investment Forum (<http://www.socialinvest.org>)

About FSG Social Impact Advisors

FSG Social Impact Advisors is a nonprofit research and strategy consulting organization that works with foundations, corporations, and nonprofits to accelerate the pace of social progress. For more information, please visit www.fsg-impact.org.

Disclaimer

As with any report of this nature, the information contained here should not be relied upon as legal advice, but rather should be used for informational purposes only as a general outline of the laws that a foundation must be aware of when engaging in the practice of mission investing. The specific legal constraints of your foundation's investments, as set out in its constitutive documents, by-laws, and investment policy, must be considered against the backdrop of relevant federal regulations and state laws. Internal and/or external counsel should be consulted as you consider and implement a mission

Organizations Consulted

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