
NONPROFIT FORUM

Prudence Perverted:
Politics, Perceptions, and Pressures

Harvey P. Dale*
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This country's Prudent Investor Rule has only recently come into reasonable harmony with the teachings of Modern Portfolio Theory and sophisticated portfolio management practices. The first section of this paper will briefly explore the history of the Rule. The next sections will discuss three instances of threats to the progress that has been made:

1. *Politics*: The Pennsylvania Attorney General's intervention to block a sale of the stock of the Hershey Company held by the Hershey Foundation, and the ensuing amendment of the relevant Pennsylvania statutes to ratify his ill-advised position,
2. *Perceptions*: The hostility of some alumni and faculty at Harvard University to the compensation paid to some staff of the Harvard Management Company (the "HMC"), leading to the resignation of those staff, the departure of the amazingly effective past-President of HMC, and an overall increase in the costs Harvard will pay for achieving effective management of its more-than-\$25 billion portfolio, and
3. *Pressures*: The ongoing efforts of some banking institutions and Attorneys General to modify the current draft of a revised Uniform Management of Institutional Funds Act by inserting mechanical-but-irrational bright line tests in lieu of wiser, if less "precise," rules of reason and good judgment.

History of the Prudent Investor Rule

Harvard College v. Amory: John McLean died in 1823 leaving what was then a substantial estate of about \$228,000.¹ Among his holdings were over \$100,000 of stock of manufacturing companies, \$48,000 of stock of insurance companies, and almost \$25,000 of stock of banking companies. He left \$50,000 in trust, the income of which was for his wife during her life, and the remainder of which (after her death) was to go equally to Harvard College and to the Massachusetts General Hospital. He named Jona-

1. That is equivalent to more than \$3 million today.

than and Francis Amory as his executors and as trustees of the trust, and in his Will directed them:

“to loan the same upon ample and sufficient security, or to invest the same in safe and productive stock, either in the public funds, bank shares or other stock, according to their best judgment and discretion”²

The Amories thus owed fiduciary duties both to John McLean’s wife, as income beneficiary, and to Harvard College and the Hospital, as remaindermen.

In early December of 1823, the executors wrote to the remaindermen suggesting that they choose a committee to consult with the executors on investments. The College and the Hospital rejected that proposal, suggesting instead that the entire \$50,000 be turned over to them, and that they would then pay the surviving spouse \$3,000 per year during her life (a fixed 6% return). On December 13, 1823, the executors wrote back, rejecting that proposal in turn, because (as they viewed it) John McLean had enjoined *them* to invest the trust assets. The executors proposed to invest in stocks according to the ratio of such holdings in the estate (they comprised about half of the estate’s assets), believing that to be what John McLean would have wished. In the alternative, the executors offered to transfer the trust property to the Hospital and the College if they would pay Mrs. McLean the sum of (1) 6% interest on \$25,000 (representing half of the trust assets), and (2) an amount equal to the dividends paid from time on \$25,000 of stock of two named manufacturing companies.

On December 20, 1823, the remaindermen wrote back, rejecting this counterproposal, and adding that they had confidence that the executors “will, in conformity to the testator’s injunction, keep the capital entire,” and — further — “that in their opinion, any investment of this capital in trade or manufactories cannot be considered by them as a safe and discreet investment.”

2. *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446, 447 (1830). The Court later clarifies the then meaning of “public funds,” when it refers to “stocks depending upon the promise of the government, or, as they are called, the public funds” *Id.* at 460. The Amories were, respectively, the brother and the cousin of Mrs. McLean. *Id.* at 461.

The battle lines were drawn. The executors proceeded to invest the entire \$50,000 fund in common stock, of which 1/6th was bank stock, just under 1/3rd was insurance company stock, and the remainder (just over 1/2) was manufacturing company stock.

The executors then filed their accounting, and cited the College and Hospital to object to it (as the law required). Although there is no evidence that Harvard College objected, the Massachusetts General Hospital *did*. On February 9, 1824, after hearing all objections, the probate court approved the executors' actions, and disallowed the Hospital's objections. No appeal was taken from this decree. The fund was turned over to the trustees (who were, of course, the same individuals).

Four years later, in October 1828, the surviving trustee, Francis Amory, presented his final account as trustee. By that time, the value of the stocks held by the trust had declined from \$50,000 to \$29,450 (although, in the interim, fairly substantial dividends — amounting to over \$20,000 — had been paid by the corporations and turned over to Mrs. McLean). The College and the Hospital objected to the settlement of Amory's accounts on various grounds. The probate court nevertheless accepted it, on January 12, 1829, and Harvard College and the Hospital appealed.

The opinion of the appellate court, per Putnam, J., is widely regarded as enlightened, flexible, and well reasoned. In response to the argument that “the manufacturing and insurance stocks are not safe, because the principal is at hazard,”³ the Court replied:

“It will not do to reject those stocks as unsafe, which are in the management of directors, whose well or ill directed measures may involve a total loss. Do what you will, the capital is at hazard. If the public funds are resorted to, what becomes of the capital when the credit of the government shall be so much impaired as it was at the close of the last war?”⁴

A few paragraphs later, after discussing the risks inherent even in mortgages and real estate investments, the Court wrote these words, which are quite famous, and are taken to be the genesis of what came to be called the “Prudent Man Rule”:

3. *Id.* at 460.

4. *Id.* at 461.

“All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.”⁵

Applying this standard, the Court held that the Amories had the right to invest in the stocks they purchased, “and that they acted in the premises according to their best skill and discretion.”⁶

Interestingly, the Court went on to discuss the earlier probate decree, of February 9, 1824, approving the accounts of the executors, from which no appeal was ever taken. It held that the earlier decree was dispositive, and protected the trustees as successors to the executors.⁷ Thus, the Court affirmed the decree of the probate judge. Given its reliance on the earlier (1824) probate decree, its justifiably famous discussion of the Prudent Man Rule is at best an alternative holding and at worst mere dictum.

Ossification and illumination. Justice Putnam’s formulation of the Prudent Man Rule involved no classification of stocks (or any other form of investment) as per se imprudent, adopting instead a flexible standard. Nevertheless, as the Rule later developed and aged — in cases, through legislation, and in scholarly commentary — its arteries hardened. In 1869, for example, the New York Court of Appeals held that common stock investments were per se imprudent.⁸ Further, “[b]y 1900 both the majority of states and the great majority of trust funds were subject to [“legal list”] statutes.”⁹ The first RESTATEMENT OF TRUSTS (in 1935) and the first edition of SCOTT ON TRUSTS (in 1939) rephrased and elaborated on the Prudent Man Rule. Because of the extraordinary influence of Professor Scott’s scholarship — he was the Reporter for the Restatement as well as the author

5. *Ibid.*

6. *Ibid.*

7. *Id.* at 463-65.

8. *King v. Talbot*, 40 N.Y. 76 (1869).

9. BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 12 (1986) [hereinafter LONGSTRETH].

of the Treatise — his words and examples had a force which is difficult to exaggerate. These were carried forward without any significant change into the second RESTATEMENT in 1959, and through two subsequent editions of his Treatise (the latter of which is dated 1967). Most current commentators agree that Scott’s formulation was much less flexible than the original.¹⁰

While the legal rules continued to become more constrained, significant new insights were beginning to emerge about how properly to analyze portfolio risk and maximize portfolio efficiency. In 1952, Harry Markowitz published a seminal paper on the theory of portfolio analysis.¹¹ Scholars in finance agree that it “is generally viewed as the origin of the modern portfolio theory approach to investing.”¹² Among its most important insights was that the total risk in a portfolio is not the sum of or even the average of the risks of the individual securities held. For example, if security A has a risk (or volatility) of 15.7 and security B has a risk (or volatility) of 12.6, the portfolio risk from holding both A and B is neither the sum (28.3) nor the average (14.15) of their separate risks.¹³ Instead, the overall portfolio’s risk depends on whether A and B positively or negatively co-vary, and to what extent. If A and B co-vary negatively, the combined portfolio risk would be less than the risk of either security taken alone. It follows that, in such a situation, adding security B (a higher-risk security) to the portfolio will *reduce* overall portfolio risk.¹⁴

10. See, e.g., Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U.L. REV. 52 (1987).

11. Harry M. Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952). See also HARRY M. MARKOWITZ, *PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS* (1959). Mr. Markowitz won the Nobel prize in economics in 1990 for his work in this area.

12. WILLIAM F. SHARPE, GORDON J. ALEXANDER & JEFFREY V. BAILEY, *INVESTMENTS* 167 (5th ed. 1995).

13. Risk, or volatility, is generally measured as the standard deviation of dispersion of returns around the mean return. See EDWIN J. ELTON & MARTIN J. GRUBER, *MODERN PORTFOLIO THEORY AND INVESTMENT ANALYSIS* 49-51 (5th ed. 1995).

14. *Id.* at 51-54. As Elton and Gruber put it, “the variance of a combination of two assets may be less than the variance of either of the assets themselves.” *Id.* at 51.

From this insight, it becomes clear that one of the greatest constraining aspects (or, from the modern perspective, sins) of the Prudent Man Rule, as it developed, was that it treated the prudence of any investment in isolation, rather than as part of an overall portfolio. This fundamental misunderstanding operated to restrict severely the development of sophisticated, efficient, and prudent portfolio management.

It took decades for the legal rules to catch up with the teachings of modern portfolio theory. By 1969, 17 years after the publication of Harry Markowitz’s paper, the enactment of § 4944 of the Internal Revenue Code — imposing an excise tax on private foundations that invest “in such a manner as to jeopardize the carrying out of any of its exempt purposes”¹⁵ — demonstrated a growing, albeit quite imperfect, awareness of proper portfolio management. Although the statute contained no definition of a “jeopardizing investment,” the regulations, adopted three years later, provided one. The good news is that the regulations demonstrated at least some familiarity with portfolio theory, stating that “[t]he 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,”¹⁶ and that “[n]o category of investments shall be treated as a *per se* violation of section 4944.”¹⁷ The beginning and end of the first quoted sentence and all of the second quoted sentence are fine; the middle language in the first sentence — requiring scrutiny “on an investment by investment basis” — is anachronistic and muddle-headed. The even worse news is that the regulations go on to call for close scrutiny of “[t]rading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of ‘puts’ and ‘calls’, and ‘straddles,’ the purchase of warrants, and selling short.”¹⁸ This emphasis on certain types of investments, without regard to their role in the overall portfolio, is seriously at odds with modern portfolio theory.

15. I.R.C. § 4944(a)(1).

16. Treas. Reg. § 53.4944-1(a)(2)(i).

17. *Ibid.* (emphasis in original).

18. *Ibid.*

The regulations later adopted under ERISA¹⁹ are more sophisticated: they only call for “a determination . . . that the particular investment or investment course of action is reasonably designed, *as part of the portfolio . . .*, to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action”²⁰

Despite these faint signs that portfolio management insights were beginning to permeate the legal scene, progress did not really begin to accelerate until the mid-1980s. In 1986, a very thoughtful and influential book was published documenting the growth of learning about prudent portfolio management, pointing out the areas where the legal rules had ossified and were in need of modification, and recommending that appropriate changes be made.²¹ In response, the American Law Institute, after careful study, in 1992 published an update to the old and sclerotic RESTATEMENT OF TRUSTS that clearly and properly sets forth the teachings of modern portfolio theory. It says that the prudent-investor standard “is to be applied to investments not in isolation but in the context of the trust portfolio and as part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.”²²

In the wake of the RESTATEMENT (THIRD), the National Conference of Commissioners on Uniform State Laws, in 1994, approved a model Uniform Prudent Investor Act.²³ According to the Commissioners, the new UPIA makes five fundamental changes in the former criteria for prudent investment:

19. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1).

20. 29 C.F.R. § 2550.404a-1(b)(2)(i) (emphasis added).

21. LONGSTRETH, *supra* n. 9.

22. RESTATEMENT OF THE LAW (THIRD), TRUSTS (PRUDENT INVESTOR RULE) § 227(a) (1992) [hereinafter RESTATEMENT (THIRD)]. Note that not only has the rule been modernized but it has become gender neutral.

23. UNIFORM PRUDENT INVESTOR ACT (1994) [hereinafter UPIA].

- The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments.²⁴ In the trust setting, the term “portfolio” embraces all the trust’s assets.
- The tradeoff in all investing between risk and return is identified as the fiduciary’s central consideration.
- All categorical restrictions on types of investments have been abrogated. The trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing.
- The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investment.
- “[T]he much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards.”²⁵

The UPIA has been quite successful, having been adopted in 43 jurisdictions as of the date of this paper.²⁶

Thus, by the end of the 20th Century — a little more than four decades after Harry Markowitz published his seminal paper — the legal rules in the U.S. had largely caught up with the lessons of modern portfolio theory and sound investment analysis.²⁷ Largely does

24. One leading commentator explained: “The key to this approach is process. Prudence is to be found principally in the process by which investment strategies are developed, adopted, implemented, and monitored in light of the purposes for which funds are held, invested, and deployed. Prudence is demonstrated by the process through which risk is managed, rather than by the definition of specific risks that are imprudent.” LONG-STRETH, *supra* note 9, at 591.

25. Prefatory Note, UPIA.

26. See Prefatory Note, UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT (draft of Feb. 8, 2006) [hereinafter UPMIFA].

27. An empirical study of the impact of UPIA concludes that its adoption significantly affected the composition of the portfolios of institutional trust funds, increasing their exposure to equities by between 1.5 and 4.5 percentage points. Max M. Schanzenbach & Robert H. Sitkoff, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio*

not mean completely, however: the portion of this paper devoted to the Hershey Foods saga, below, will describe legislative back-sliding on the Pennsylvania version of the Prudent Investor Rule, and the portion devoted to “pressures,” below, will discuss certain ongoing obstacles facing the effort to modernize the 1972 version of the UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT.²⁸

Diversification. A brief discussion of diversification is relevant here not only because of its importance to modern portfolio theory and in the UPIA but because it is critical to an analysis of the Hershey Chocolate story, to be considered below. The central importance of diversification derives not from the law but from the core insights of modern portfolio theory and a great deal of supporting empirical research.²⁹ One such insight is that return and risk are correlated, i.e., that low-risk assets are priced by the market to produce lower returns than higher-risk assets. That makes obvious common sense, because rational investors would require higher returns if they are to accept higher risk.³⁰ A prudent investor will invest in higher-volatility securities if he or she believes that the total returns to them, over a suitable time horizon, will appropriately exceed the total returns accruing to lower-volatility securities. Vast amounts of empirical data support this insight.

The market, however, only rewards what is sometimes called systemic, rather than specific, risk. For example, equities in general are more volatile than fixed-income securities, and over long time periods holders of a basket of equities can expect, with a high degree of confidence, to earn more than holders of bonds. (This is sometimes referred to as the “equity premium.”) However, the market does not generally reward an investor who selects and holds only the stock of, for example, the Ford Motor Company rather than a

Allocation?, NYU LAW & ECONOMICS RESEARCH PAPER No. 05-30 (Dec. 5, 2005), available at <http://ssrn.com/abstract=868761>.

28. Hereinafter cited as “UMIFA.”

29. For a good general discussion of the importance of portfolio diversification, see John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. L. REV. 1105, 1113-14 (2004). Of course, the law does mandate diversification in most situations. See, e.g., RESTATEMENT (THIRD) § 227(b); UPIA § 3 (1994).

30. “Risk,” for these purposes, is simply volatility, i.e., the likelihood of price fluctuations.

diversified portfolio of stocks. Empirical studies have shown that security-specific risk is not compensated in the market. A prudent fiduciary would not expose a portfolio to risk without a commensurate expectation of reward.³¹ Thus, diversification is crucial because it avoids security-specific (and thus uncompensated) risk while maintaining (and permitting calibration of) systemic (and thus compensated) risk. Diversification involves holding securities that exhibit at least some degree of negative co-variance, i.e., whose market values are not likely to fluctuate the same amount in the same direction at the same time.

Politics: The Hershey Saga

Establishment of the Trust. Milton S. Hershey was born in Lancaster, Pennsylvania, on Sept. 13, 1857.³² He left school when he was 12, and soon thereafter began working at an ice cream parlor in town.³³ Although he failed in various ventures over many years, he never worked in any field but confections. By his late 30s, however, he had become extremely successful running a caramel factory and later a chocolate factory.

31. As the comments to the UPIA express it: “Modern portfolio theory divides risk into the categories of ‘compensated’ and ‘uncompensated’ risk. The risk of owning shares in a mature and well managed company in a settled industry is less than the risk of owning shares in a start-up high-technology venture. The investor requires a higher expected return to induce the investor to bear the greater risk of disappointment associated with the start-up firm. This is compensated risk — the firm pays the investor for bearing the risk. By contrast, nobody pays the investor for owning too few stocks. The investor who owned only international oils in 1973 was running a risk that could have been reduced by having configured the portfolio differently — to include investments in different industries. This is uncompensated risk — nobody pays the investor for owning shares in too few industries and too few companies. Risk that can be eliminated by adding different stocks (or bonds) is uncompensated risk. The object of diversification is to minimize this uncompensated risk of having too few investments. ‘As long as stock prices do not move exactly together, the risk of a diversified portfolio will be less than the average risk of the separate holdings.’ R.A. Brealey, *An Introduction to Risk and Return from Common Stocks* 103 (2d ed. 1983).” UPIA § 3, Comment.

32. MICHAEL D’ANTONIO: *MILTON S. HERSHEY’S EXTRAORDINARY LIFE OF WEALTH, EMPIRE, AND UTOPIAN DREAMS* 12 (2006) [hereinafter D’ANTONIO]. For additional reading on M.S. Hershey and his “empire,” see JAMES D. MCMAHON, *BUILT ON CHOCOLATE: THE STOREY OF THE HERSHEY CHOCOLATE COMPANY* (1998); JOEL GLENN BRENNER, *THE EMPERORS OF CHOCOLATE: INSIDE THE SECRET WORLD OF HERSHEY AND MARS* (2000).

33. D’ANTONIO at 25.

When he was 40, he married Catherine Sweeney, then 25 years old, in a New York City ceremony to which no relative from either family came.³⁴

Unable to have children of their own,³⁵ Hershey and his wife decided to establish a home and school for orphaned boys in the township of Derry, Pennsylvania, where the Hershey chocolate factory was located and where Milton Hershey had established a planned community.³⁶ On November 15, 1909, the Hersheys signed a Deed of Trust providing for the establishment and operation of the Hershey Industrial School, since renamed the Milton Hershey School.³⁷ The deed provided that the School be located in Derry; preferences for admission were given, in order of priority, to children born in certain Pennsylvania counties, to children born in the rest of the state of Pennsylvania, and to children born elsewhere in the U.S.³⁸ To fund the School, the trust (“the trust” or “the Hershey Trust”) was originally endowed with 486 acres of farmland.³⁹

The death of Catherine Hershey in 1915 prompted Milton Hershey to turn his attention to the School, which he had always credited as his wife’s idea.⁴⁰ Subsequently, Milton Hershey transferred the bulk of his wealth, consisting of \$60 million in Hershey

34. D’ANTONIO at 80.

35. Catherine was sickly, probably as a result of syphilis. There is some reason to believe that she contracted the disease while working in Buffalo before meeting M.S. Hershey. D’ANTONIO at 93-94.

36. The planned community established by Milton Hershey is the town of Hershey, which is located within the township of Derry, Pennsylvania. Milton Hershey School, Second Restated Deed of Trust (Nov. 15, 1976) *available at* http://www.mhs-pa.org/docs/webdocs/Deed_of_Trust.pdf (copy on file with author) [hereinafter Hershey Trust Deed].

37. *Id.*

38. Hershey Trust Deed § 14.

39. The land included the homestead on which Milton Hershey was born. *Id.* Somewhat confusingly, a 2005 decision of the Commonwealth Court of Pennsylvania states that “[t]he Hersheys originally contributed 12,000 acres of land to the corpus of the trust” Milton Hershey School, 867 A.2d 674, 676-77 (Pa. Commw. 2005). No ready explanation could be found for the discrepancy between 486 acres and 12,000 acres.

40. http://www.hersheys.com/discover/milton/fund_school_trust.asp (on file with author).

Foods Corporation stock and other assets, to the trust.⁴¹ The trust is administered by its trustee, the Hershey Trust Company, and by Managers appointed by the trustee. The Managers are also members of the Board of Directors of the trust company.⁴² The deed grants the trustees and Managers the following discretion in making investment decisions:

The funds of the principal of the trust estate and the unexpended income of the property held in trust, not immediately needed for the purposes of the School, shall be invested, and the Trustee at all times by and with the authority and approval of the Managers shall have full power and authority to invest all or any part thereof in any securities which the Trustee and the Managers may together consider safe, whether the said securities or any of them are legal investments for trust funds or not, and neither the Trustee nor the Managers shall be held accountable for the exercise of its and their discretion, exercised in good faith, as to the character of the investments which may be made by the authority and approval of both.⁴³

The trustees are also authorized, with the approval of the Managers, to sell any securities the trust may hold.⁴⁴ Indeed, the trust deed even explicitly authorizes the sale of all or any part of the land that was initially conveyed to the trust as inception assets.⁴⁵

There is nothing in the Hershey Trust Deed indicating that the Hersheys had any intention to benefit any persons, community, or institution except the School. In fact, the deed explicitly provides that all of the assets shall be held only and exclusively “in trust for a permanent institution for the residence and accommodation of poor children”⁴⁶ It goes on to provide that “[n]o part of the corpus or principal of the trust estate, or of the income . . . or other accretions thereto . . . shall at any time be applied to any other purpose or purposes than those herein mentioned and appointed”⁴⁷

41. *Id.* The donation was made secretly on Nov. 13, 1918; the public became aware of it only years later when the New York Times, on Nov. 9, 1923, printed a front-page article disclosing the facts. D’ANTONIO at 169, 179.

42. Milton Hershey School, 867 A.2d 674, 677 (Pa. Commw. 2005).

43. Hershey Trust Deed § 5.

44. Hershey Trust Deed § 5.

45. Hershey Trust Deed § 6.

46. Hershey Trust Deed at 3.

47. Hershey Trust Deed § 8.

For seven decades, the trustees managed the School.⁴⁸ In addition, the trust owned a controlling interest in Hershey Foods, and was involved in several other general philanthropic endeavors around the town of Hershey.⁴⁹ The trust's current assets total more than \$6 billion today and include an ownership of approximately 30% of Hershey Foods.⁵⁰

Alumni stir the pot. The history of the trust has never been free of conflict, particularly that initiated by the Milton Hershey School Alumni Association, an activist group of graduates. For example, in the late 1990s, the trust proposed devoting \$75 million in surplus trust income to the establishment of a teacher training institute.⁵¹ The *cy pres* petition to the local court brought raucous opposition from the Alumni Association, which opposed any diversion of support from the School.⁵² The Alumni Association enlisted the

48. The same managers managed the Hershey Trust and the school until the summer of 2002. Mark Sidel, *The Struggle for Hershey: Community Accountability and the Law in Modern American Philanthropy*, 65 U. PITT. L. REV.1, 5 n.7 (2003).

49. *Id.* at 5.

50. http://www.hersheys.com/discover/milton/hershey_ind_school.asp (on file with author). The Pennsylvania Commonwealth Court used the figure of \$5.5 billion for the value of the trust assets, although acknowledging that the value might well exceed \$6 billion. Milton Hershey School, 867 A.2d 674, 678 and n.1 (Pa. Commw. 2005). As at Dec. 31, 2004, the trust owned 14,112,604 (7.63%) out of a total of 184,977,601 shares of Class A Common Stock outstanding, and 60,612,012 (99.63%) out of a total of 60,836,826 shares of Class B Common Stock outstanding. The Class B shares are entitled to ten votes per share whereas the Class A shares are entitled to one vote per share. Thus, the trust then held 78.18% of the total voting power. The Class A shares, however, are entitled to cash dividends 10% higher than those paid on the Class B shares. Ignoring this difference, the trust held shares representing 30.40% of the total equity in Hershey Foods; treating this difference in dividend rights as reflecting a higher share of total equity in the Class A shares, the trust's shares represented 28.64% of the total equity in Hershey Foods. The Class B shares are convertible into Class A shares on a share-for-share basis at any time. Hershey Foods Corp., Annual Report (From 10-K), at 65-66 (Mar. 7, 2005).

51. Sidel, *supra* note 48, at 5.

52. *Id.*

help of then Pennsylvania Attorney General D. Michael Fisher, who opposed the plan in court.⁵³ Eventually, the local court barred the trust's plans.⁵⁴

The Alumni Association's concerns over the management and operation of the school continued to escalate. As a result, exhaustive inquiries initiated by both the school and the Attorney General's office were conducted throughout 2000 and 2001.⁵⁵ In 2002, the trust, the school and the Attorney General reached a "reform agreement" with respect to structural reforms that were intended to improve administration of the Hershey Trust.⁵⁶

After this reform agreement was executed, litigation arose over the proposed diversification of the trust assets and the sale of the trust's controlling interest in Hershey Foods. As a result, the leadership of the Hershey trust company and management of the school were reorganized.⁵⁷ Accordingly, the trust, the school, and the Attorney General executed a new reform agreement in 2003, and the Alumni Association brought suit seeking to challenge this agreement.⁵⁸ Overturning the lower court, the Commonwealth Court held that because the Alumni Association had a "special interest" in the proceeding, it had standing in the case and should have been allowed to challenge the modification of the original 2002 reform agreement.⁵⁹ The trust, the school, and the Attorney General have filed an appeal on this issue.⁶⁰

53. Catherine Gewertz, *Alumni, Administrators Lock Horns at Hershey School*, EDUC. WK., Dec. 13, 2000 at 12, 13.

54. *Id.*

55. *In re Milton Hershey School*, 867 A.2d 674, 679 (Pa. Commw. 2005); Gewertz, *supra* note 53; Sidel, *supra* note 48, at 5.

56. 867 A.2d at 679.

57. *Id.* at 680.

58. *Id.* at 680-681.

59. *Id.* at 690-91. In its extensive analysis of charitable standing, *id.* at 685-91, the Court relied heavily on, and quoted extensively from, Mary Grace Blasko, et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37 (1993), and explicitly adopted the multi-factor test suggested in that article. The article was written by New York University Law School students under the supervision of professors at the National Center on Philanthropy and the Law. The Court also cited to Evelyn Brody, *Whose Public? Parochialism*

The attempt to diversify. Until 1999, when the State adopted the Prudent Investor Rule,⁶¹ charitable trusts in Pennsylvania were not legally required to diversify their portfolios. Even after the Prudent Investor Rule — including its diversification requirement — was adopted, it did not apply to trusts in existence prior to its enactment; therefore, the Hershey Trust was exempted from its diversification mandate.⁶² (Of course, this did not mean that prudent trustees *should* not diversify the trust’s portfolio; it only meant that they were not *required* to do so by the statute.) Notwithstanding this lack of a legal mandate, the trust began a gradual process of diversification in the 1980s, bringing its holdings in Hershey Foods down from approximately 80% of its assets in the early 1980s to 52% of its assets in mid-2002.⁶³ Still, even with this diversification, the trust controlled 77% of Hershey Foods stock.⁶⁴

Most of this diversification came in the form of a stock repurchase program initiated by Hershey Foods. However, seeking to capitalize on the control premium available on the open market,⁶⁵ in March of 2002 the Hershey Trust Board agreed to explore any and all options that would disentangle the trust from its investment in Hershey Foods, including the sale of the company.⁶⁶ Although the trust’s chief executive officer promised, “[B]efore we would accept any bids, we would have to be convinced that this community will be protected,” public outcry ensued and intensified rapidly.⁶⁷ Protests were launched,

and Paternalism in State Charity Law Enforcement, 79 IND. L. REV. 937 (2004). *Id.* at 686 n.22.

60. *In re Milton Hershey School*, 2005 PA. LEXIS 2695.

61. 20 PA. CONS. STAT. ANN. § 7201, official cmt. (West 1999) (indicating that certain sections of the UPIA were not adopted).

62. 20 PA. CONS. STAT. ANN. § 7204

63. Sidel, *supra* note 48, at 6-7.

64. *Id.* at 12.

65. The Hershey Foods buy-backs were at the market value for the publicly-traded Class A shares and thus did not reflect any premium for the control held by the trust.

66. Sidel, *supra* note 48, at 10.

67. Bill Sulon, *Hershey Foods Furor; Trustees Pledge Goal of Protecting Community*, PATRIOT-NEWS (Harrisburg), July 26, 2002, at A1

and newspapers printed numerous articles voicing their opposition and detailing the plight of other towns when they “lost the company.”⁶⁸

Initially, state regulators supported the trust’s plans to diversify; on several occasions, the Attorney General’s office had expressed concern over the trust’s need to do so.⁶⁹ However, in the midst of the panic over the proposed sale, Attorney General Fisher saw an opportunity. Fisher, who at the time was the Republican candidate for governor of Pennsylvania, petitioned the local courts in his capacity as Attorney General to require the Hershey Trust to show cause why the sale of its controlling interest should not require court approval, and to enjoin the trust from selling its Hershey Foods shares until a hearing could be held on the matter.⁷⁰ The injunction was issued by the Dauphin County Orphans’ Court and affirmed by the Commonwealth Court, which stated:

The Attorney General has sufficiently carried his burden of proving the potential harm that he seeks to prevent, namely, the adverse economic and social impact against the public interest if a sale of Hershey Foods Corporation takes place, particularly in its effect on employees of the Corporation and the community of Derry Township.⁷¹

Soon after the injunction was upheld, the Hershey Trust Board met to consider offers on the table for its stake in Hershey Foods. After an 11-hour meeting, the Board voted not to accept any offers and to terminate the Hershey sale process.⁷² Press and other reports indicated that the high bidder was Wrigley, the Chicago-based privately-held gum

68. Brett Lieberman et al. “*When Other Towns Have Lost ‘The Company,’*” PATRIOT-NEWS (Harrisburg), July 28, 2002, at A20.

69. However, the Attorney General’s office denies that its concern was ever meant to encourage sale of the company. Sidel, *supra* note 48, at 9; Sarah Ellison, *Sale of Hershey Foods Runs Into Opposition*, WALL ST. J., Aug. 26, 2002, at A3.

70. The Attorney General would later claim in a campaign advertisement that he “saved 6,000 midstate jobs” by stopping the sale of Hershey Foods. Jennifer L. Komoroski, Note, *The Hershey Trust’s Quest to Diversify: Redefining the State Attorney General’s Role When Charitable Trusts Wish to Diversify*, 45 WM. & MARY L. REV. 1769, 1787 (2004).

71. *In re Milton Hershey School Trust*, 807 A.2d 324, 331 (2002). Judge Pellegrini filed a strong dissent. *Id.* at 335 et seq.

72. Sidel, *supra* note 48, at 26.

and confectionary company; that it had been willing to pay \$12.5 billion in cash and stock; and that it had been willing to make certain guarantees for jobs and the continued viability of the Hershey factories.⁷³

Changes in Pennsylvania law. As a direct result of the Hershey debacle, the Pennsylvania legislature sought to change the state’s Prudent Investor Rule so as to prevent the situation from ever recurring.⁷⁴ In its amendment, the legislature gave the Attorney General power to seek a judicial review in cases where the Attorney General believes that a charitable trust should be stopped from effectuating a change in control of a public corporation.⁷⁵ Once this judicial review is initiated by the Attorney General, the trustees of such a charitable trust are required to “prove by clear and convincing evidence that executing the change in the trust’s control of the corporation is necessary to maintain the economic viability of the corporation and prevent a significant diminution of trust assets or to avoid an impairment of the charitable purpose of the trust.”⁷⁶

The “Hershey bill,” supported by the then Attorney General,⁷⁷ was fast-tracked by the legislative leadership, and it was adopted by the Pennsylvania Senate with no recorded debate and only one dissenting vote.⁷⁸ It came under increased scrutiny, however, in the Pennsylvania House. During that debate, State Representative Nickol raised numerous issues with the bill, and questioned whether it was designed specifically to benefit Hershey,

73. Dan Ackman, *Hershey Says No, Bankers Cry Foul*, FORBES.COM, Sept. 18, 2002 at <http://www.forbes.com/2002/09/18/0918topnews.html>.

74. See 20 PA. CONS. STAT. ANN. § 7203 (West 2002) (amending 20 PA. CONS. STAT. ANN. § 7203 (West 1999)).

75. 20 PA. CONS. STAT. ANN. § 7203(d)(2) (West 2002).

76. 20 PA. CONS. STAT. ANN. § 7203(d)(3) (West 2002).

77. See *Milton Hershey School*, 867 A.2d 674, 686 n.21 (Pa. Commw. 2005).

78. Sidel, *supra* note 48, at 40 (quoting S. 186-60, 1st Sess., at 2226-27 (Pa. 1994) in *Legislative Journal of Pennsylvania Senate*, 186th of the General Assembly, at 2226-27 (Oct. 9, 2002)).

noting that such a law would contravene the state constitution.⁷⁹ However, his motion to recommit the bill for a public hearing did not pass; the Hershey bill was adopted by a wide margin and eventually was signed into law.⁸⁰ In addition to the above-quoted provision, it adds to the Pennsylvania version of the Uniform Prudent Investor Act a paragraph requiring that trustees thinking of selling a trust asset must consider:

an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries, including, in the case of a charitable trust, the special relationship of the asset and its economic impact as a principal business enterprise on the community in which the beneficiary of the trust is located and the special value of the integration of the beneficiary's activities with the community where that asset is located.⁸¹

One wise commentator said of this provision, "it represents an unusual degree of interference with trustee discretion, not to say a perversion of the intent of many donors."⁸² In my opinion, that is understatement.

Milton's views. In the midst of the turmoil accompanying the deliberations of the trust about a possible sale of the Hershey stock, some angry opponents of such a sale claimed that Milton Hershey would never have permitted it to occur. In fact, however, M.S. Hershey had come very close to selling the stock on two occasions:

- In the summer of 1929, Mr. Hershey signed an option permitting his bankers to buy a significant portion of the Hershey stock from the trust. The bankers were seeking to acquire the Hershey Company, amalgamate it with other confectionary businesses, and then sell shares in the resulting conglomerate to the public at a

79. Sidel, *supra* note 48, at 42 (quoting H.R. 186-69, 1st Sess., at 1936 (Pa. 1994) in Legislative Journal of Pennsylvania House, 186th of the General Assembly, at 1936 (Oct. 22, 2002)).

80. *Id.*

81. 20 PA. CONS. STAT. ANN. § 7203(c)(6) (West 2002).

82. MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 193 (2004).

profit. The stock market crash in late September and October of 1929, however, made such an offering impossible, so the option was never exercised.⁸³

- In his early 80s, after recovering from a mild heart attack or a stroke, Mr. Hershey again decided to sell the Hershey Company stock held by the trust. Responding to advice from a trusted advisor about the wisdom of diversification, he reportedly said, “I have been thinking about what you said,” and “I think you are right. Let’s go to work.” However, the sale never occurred. Milton Hershey’s advisor later said that the only thing that prevented the sale was “the inertia of old age.”⁸⁴

Of course, because the trust deed explicitly permits a sale, even if Mr. Hershey would have opposed it if alive, the trustees would be both authorized and prudent to proceed with a diversifying disposition of the Hershey Company stock. To the extent, however, that opponents of a sale invoke his wishes in support of their position, the above facts tend to weaken their claim.

The AG’s position. The Attorney General — while arguing that he was representing not only the School but also the “community” and the “general public” — provided no guidance about how he proposed to balance the possibly competing claims among those constituencies. In the absence of well-articulated, clear, and principled guidelines, two evils result: (1) honest fiduciaries, trying in good faith to discharge their duty of prudence by diversifying a charity’s portfolio, may be unable to discern what the position of the Attorney General would be in any particular case, and (2) the potential is created for abuses of discretion by a self-interested AG. Suppose, for example, that instead of the high bidder for the Hershey Company stock being Chicago-based Wrigley it was XYZ company from a different county in Pennsylvania. How would the AG weigh the varying interests of the School, the “community,” and the “general public”? Suppose that XYZ’s county had 3,000 more registered Democrats than Republicans, while the Hershey Company’s

83. D’ANTONIO at 193-95. Milton Hershey later apparently changed his mind about the sale to which he had agreed, saying that the market crash’s prevention of the deal was “the best thing that ever happened.” *Id.* at 195.

84. D’ANTONIO at 223-24.

home county was overwhelmingly either Democratic or Republican. How might an AG then running for Governor on the Republican ticket weigh the interests of the School, the “community,” and the “general public” if he thought that by encouraging the sale he could claim to have created new jobs for 6,000 employees in XYZ’s county, at least some of whom might be grateful to him?⁸⁵ (Of course, one could also hypothesize a case in which XYZ’s county was overwhelmingly either Democratic or Republican whereas Hershey’s home county was nearly in political equipoise — in which case the AG’s weighing of the circumstances might be influenced in the opposite direction, i.e., against a sale.)

The core problem is the Attorney General’s, and the Orphans’ Court’s, astonishing expansion of the AG’s role as protector not of the beneficiaries of the trust but of some undefined “public interest.” Under the cover of the potentially vast scope of that concept many evils might emerge. Suppose an Attorney General in state Z was a firm and sincere believer that physician-assisted suicide was equivalent to murder and morally wrong. Suppose further that a charitable organization in Z was created and funded for the purpose of promoting the concept of death with dignity. Would the AG, claiming to represent the public interest, be justified in preventing the charity from selling its portfolio at a profit? This example does not involve the interests of any particular local “community,” but the Pennsylvania AG’s argument was not limited to such circumstances, nor was the opinion of the Orphans’ Court. This example also does not explicitly involve a potential sale of a controlling block of a publicly-held corporation, but again neither the AG’s nor the Orphans’ Court’s language is limited to such circumstances. As to the possibility of such an astonishing position ever realistically being taken by an Attorney General, consider the fact that ex-Attorney General John Ashcroft, in an effort to prevent the Oregon Death With Dignity Act from becoming effective, attempted to apply the federal Controlled Substances Act to deny Oregon doctors the right to prescribe medications for those purposes — an

85. Attorney General Fisher, in a campaign advertisement during his race for Governor, claimed that he saved 6,000 jobs by stopping the sale of the Hershey Company stock. Komoroski, *supra* note 70, at 1787, quoting Peter L. DeCoursey, *Fisher Ad Seizes on Hershey Sale Halt; GOP Hopeful Claims He Saved 6,000 Jobs*, HARRISBURG PATRIOT NEWS, Sept. 26, 2002, at B1.

attempt that ultimately failed only as a result of a 6-3 decision of the Supreme Court in January of 2006.⁸⁶

While it may be true in some sense that a charity must operate in the public interest, and that therefore the Attorney General has some modest role in determining whether that is so in any particular case, it does not and emphatically should not follow that an AG is free to seek to redirect charitable resources from the objects and beneficiaries selected by the donors to some other objects or persons the AG prefers. Even if the AG's views are completely sincere, free from self-interest, and inspired solely by the AG's good faith understanding of what is in the "public interest," the pluralism — and indeed the cherished cacophony — of the charitable sector would be seriously impaired by an AG's attempt to redirect resources to causes and persons the AG favors and away from the causes and beneficiaries to which the charity is dedicated. Concurring in Bob Jones University, Justice Powell expressed his concern even about constraining charities to avoid violating "fundamental public policy." His wise words are apposite:

Even more troubling to me is the element of conformity that appears to inform the Court's analysis. The Court asserts that an exempt organization must "demonstrably serve and be in harmony with the public interest," must have a purpose that comports with "the common community conscience," and must not act in a manner "affirmatively at odds with [the] declared position of the whole government." Taken together, these passages suggest that the primary function of a tax-exempt organization is to act on behalf of the Government in carrying out governmentally approved policies. In my opinion, such a view . . . ignores the important role played by tax exemptions in encouraging diverse, indeed often sharply conflicting, activities and viewpoints. As Justice Brennan has observed, private, nonprofit groups receive tax exemptions because "each group contributes to the diversity of association, viewpoint, and enterprise essential to a vigorous, pluralistic society." Far from representing an effort to reinforce any perceived "common community conscience," the provision of tax exemptions to nonprofit groups is one indispensable means of limiting the influence of governmental orthodoxy on important areas of community life. Given the importance of our tradition of pluralism, "[t]he interest in preserving an area of untrammelled choice for private philanthropy is very great."

86. *Gonzales v. Oregon*, 546 U.S. ___, 126 S.Ct. 904 (2006).

Jackson v. Statler Foundation, 496 F.2d 623, 639 (C.A.2 1973)(Friendly, J., dissenting from denial of reconsideration en banc).⁸⁷

To the extent that the Pennsylvania AG asserted such a expansive and dangerous role, future officials and courts should repudiate and restrict such an assertion. To the extent that the Orphans' Court endorsed such a role for the AG, future court opinions should repudiate and restrict its language and opinions.

Comments to the RESTATEMENT (THIRD) make clear that a trustee may not take into account considerations of social value — such as the impact of the trust's investment decisions on its “community” or the “general public” — unless they directly contribute to the charitable purposes of the trust. Thus:

“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.”⁸⁸

Further:

“[i]n administering the trust the trustee is under a duty to the beneficiaries not to be influenced by the interest of any third person or by motives other than the accomplishment of the purposes of the trust. Thus, it is improper for the trustee to purchase property for the trust or to sell trust property for the purpose of benefiting a third person rather than the trust estate or for the purpose of advancing an objective other than the purposes of the trust.”⁸⁹

The comments to the UPIA are even more forceful:

“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 benefitted by pursuing the particular social cause.”⁹⁰

87. Bob Jones University v. United States, 461 U.S. 574, ??? (1983).

88. RESTATEMENT (THIRD) § 227, comment c, at 13.

89. RESTATEMENT (THIRD) § 170, comment q, at 140.

90. UPIA § 5, comment.

Under these admonitions, it is hard to see how the Hershey School trustees, as loyal fiduciaries, could properly and prudently have considered the interests of the “community” or the “general public” as relevant to their diversification decision at all, much less as being so weighty as to overcome their otherwise clear duties to diversify and capture the value of the control premium they held.

Other articles on Hershey. Commentators on the Hershey saga have been uniformly critical of the actions of the Attorney General, the Orphans’ Court, and the legislature. Prof. Sidel, for example, observes that the Attorney General adopted “a considerably more intrusive position” than typical, and one that was “clearly influenced by politics.”⁹¹ He concludes that the Orphans’ Court asserted its role “in a particularly expansive fashion,”⁹² and that its jurisprudence was “defiantly extensive.”⁹³ He states that the legislature was guilty of “over-action”⁹⁴ and that its intervention was “dangerous.”⁹⁵ Prof. Brody opines that “each of the three branches of Pennsylvania government [was] acting illegitimately,” and that “[t]he attorney general practically treated the Hershey assets as his election campaign funds.”⁹⁶ Marion Fremont-Smith correctly characterizes the legislature’s action as constituting “interference with trustee discretion” and “a perversion of the intent of many donors.”⁹⁷ I agree with each of these criticisms, but I have disagreements with two of those authors, in each case because I believe they have been unduly kind, rather than sufficiently censorious. Taking the two in order:

First, Prof. Brody writes that “the legislature singled out the Trust and effectively appropriated to the local community locked-in control of a publicly traded corporation —

91. Sidel, *supra* note 48, at 33.

92. *Id.* at 36.

93. *Id.* at 39.

94. *Id.* at 39.

95. *Id.* at 44.

96. Brody, *supra* note 59, at 998.

97. See text accompanying note 82, *supra*.

without, of course, rising to the level of a ‘taking’ requiring payment of compensation.”⁹⁸ I start by observing that even a compensated taking may inspire heated controversy, in some circumstances raising serious constitutional issues, as illustrated by the recent 5-4 Supreme Court decision involving the city of New London’s exercise of eminent domain to promote community economic development.⁹⁹ It is obviously worse if, as Prof. Brody states, the legislature’s action appropriates property *without* compensation. In the Hershey situation, however, there is no evidence that the control premium — amounting in all likelihood to about \$1.2 billion¹⁰⁰ — was transferred to the local community: it is hard to believe and would be virtually impossible to show that the town received a \$1.2 billion benefit as a result of the blocking of the Hershey sale. Thus, this “taking” was not only without compensation, it altogether destroyed at least a significant portion of the control premium value. That, I suggest, is worse yet than what Prof. Brody postulated, because the wanton trashing of \$1.2 billion of charitable assets is even more disgraceful than a forced uncompensated transfer of assets to some other arguably worthwhile purpose.¹⁰¹

Second, Prof. Sidel, after incisively critiquing the actions and roles of the Attorney General, the Orphans’ Court, and the legislature, very surprisingly concludes his article by setting forth an apologia for the conduct of the AG. He argues that “a substantial role for the state Attorney General . . . worked reasonably well in *Hershey*.”¹⁰² He elucidates:

Political dialogue and representation — in this case the active oppositional role of the community, and even the political aspirations of the state Attorney General —

98. Brody, *supra* note 59, at 999.

99. *Kelo v. City of New London*, 125 S.Ct. 2655, 162 L.Ed.2d 439, ___ U.S. ___ (2005).

100. The Wrigley offer was reported to involve a 42% premium for control. Brody, *supra* note 59, at 995, citing to Steven Pearlstein, *For Hershey Trust, the Outcome is Bittersweet*, WASH. POST, Sept. 19, 2002, at E1. Hershey Foods shares constituted just over half of the trust’s assets in 2002. See text accompanying note 63, *supra*. The aggregate value of the trust’s assets in 2002 was approximately \$6 billion. See text accompanying note 50, *supra*. Rounding to avoid spurious precision, 40% of 50% of \$6 billion is \$1.2 billion.

101. Based on communications between us, I believe that Prof. Brody concurs with these observations and would wish to associate herself with my views.

102. Sidel, *supra* note 48, at 57.

helped to spur a flexible consideration of the appropriate *parens patriae* role of the Attorney General at different points in a rapidly moving and fluid process, rather than allowing the definition of *parens patriae* interests to be immutably fixed or remain unaffected by the views of the very public that the *parens patriae* is supposed to represent.¹⁰³

Further:

[T]he system did work. It provided a framework for a dynamic reconsideration of what the *parens patriae* interest really is, informed not entirely by isolated regulators conferring with legal texts but necessarily, forcefully informed by public attitudes, the views of those directly affected, and broader representational forces. While that process occurred during, and appears to have been influenced by, a political and electoral process, that political process served as a transmission belt for public attitudes to be conveyed, for more information to be ascertained, and ultimately for a result to be achieved that directly addressed the questions of fiduciary duty and trustee responsibility with which the Hershey Trust Board wrestled. Here the changing nature of public interest under *parens patriae*, and the influence of political dialogue, was not an unfortunate concomitant or product of the process — it was integral to it, and, I would argue resulted in a better and more informed solution.¹⁰⁴

I could not disagree more strenuously. What Prof. Sidel calls “flexible” I would label “unprincipled.” What he praises as a process that allowed political and public opinions to be inserted I would condemn as a process that created confusion and often will produce whimsical and oppressive results, particularly if those who assert political or public views happen to be in disagreement with the mission of the charity in question. What he describes as “a better and more informed solution” I would call a capricious, intrusive, and destructive outcome. The Prudent Investor Rule was perverted; substantial assets of a charitable institution were destroyed; trustees seeking prudently to diversify and to capture the control premium value of the assets they held as fiduciaries were removed from office; other Pennsylvania fiduciaries interested in performing their jobs in good faith are left with no guidance about how to ascertain what a future Attorney General might claim to be in the interest of the “community” or the “public interest”; and the Hershey Company itself was legislatively insulated against market forces that elsewhere operate to allo-

103. *Id.* at 58.

104. *Id.* at 59.

cate capital more efficiently to well-run rather than management-embedded businesses. (In addition, the Attorney General was soundly defeated in the race for Governor, raising at least some questions about his ability to discern and represent the “public interest.”)

Unintended consequences. Two significant unintended consequences follow from the position taken by the Pennsylvania Attorney General and the subsequent legislative changes to the State’s Prudent Investor Act. The first is that well-advised donors may choose to organize their endowed charities outside of Pennsylvania in order to avoid what at least sometimes will be perceived as the risk of intrusive and even capricious distortions of their charitable intentions.¹⁰⁵

The second is a loss of power to the Office of the Attorney General. Recall that the Attorney General explicitly argued that his office represented not only the interests of the stated beneficiaries of the Hershey Trust, i.e., the children at the Hershey School, but also the interests of “the community” and “the public.” Although the School argued against this view, the Orphans’ Court opined that “the beneficiary of charitable trusts is the general public”¹⁰⁶ and that “because the socio-economic benefits of a charitable trust ex-

105. It should not be uncritically assumed that such out-of-state formation will always be effective to avoid Pennsylvania’s now-deformed legal infrastructure affecting “prudent” investing. It is, however, beyond the scope of this paper, and the legal knowledge of its author, to discuss the scope of the “internal affairs” doctrine, its application to investment-management decisions, or the circumstances under which a state in which a charity conducts various activities may assert its own legal rules in lieu of the legal rules of the charity’s state of formation. See generally Antonia Grumbach, *State Regulation of the Internal Affairs of Foreign Not-for-Profit Corporations: An Exploratory Discussion*, delivered to the Nonprofit Forum on Oct. 19, 2005, on line at <http://www.law.nyu.edu/npf>; Douglas M. Mancino, *California Regulation of Out-of-State Charities*, 19 TAX’N EXEMPTS (forthcoming March-April 2006). Of course, an overly aggressive assertion of jurisdiction by a non-formation state, based on the existence of activities within it by a foreign charity, might deter charities not only from organizing within that state but also from designating beneficiaries or conducting activities within that state. Recognizing this deterrent effect, it is not uncommon for jurisdictions to reduce, rather than increase, regulatory and fiscal burdens on in-jurisdiction activities of foreign persons. Cf. I.R.C. § 864(b)(2)(A)(ii) permitting foreign persons to trade securities within the U.S., even through discretionary U.S. agents, without being treated as engaged in trade or business within the U.S.

106. Opinion of Morgan, J., attached to the reported opinion in *In re Milton Hershey School Trust*, 807 A.2d 324, 327 *et seq.* (Pa. Commonw. 2002), at 330.

tend beyond the designated beneficiaries to the public itself, although ordinarily compatible with each other, the Attorney General has an added responsibility of assuring that compatibility.”¹⁰⁷ This expansive view creates a risk of conflict of interest on the part of the Attorney General, whose office can no longer be seen to be acting solely for the beneficiaries.

This potential conflict has been noticed not only by commentators¹⁰⁸ but by the Pennsylvania Courts. In a later litigation, the Hershey Alumni Association challenged an agreement between the Office of the Attorney General and the Hershey School modifying an earlier agreement between them that had provided for certain School governance reforms. The Hershey School and the Hershey Trust Company objected, claiming that the Alumni Association lacked standing. The Orphans’ Court agreed, and dismissed the Alumni Association’s complaint. On appeal, however, the Commonwealth Court reversed. It noted the conflict of interest issue:

“Unlike other states, however, the OAG takes the position that it has the power to oppose that which may be in the best interests of the trust and examine the effects that the actions of the trust have on the larger community. In its petition opposing the Trust’s proposed sale of its controlling interest in HFC, the OAG acknowledged that the sale would likely diversify and increase the assets of the Trust, but nonetheless objected to the sale because any sale would have profound negative consequences for the Hershey community and surround areas”¹⁰⁹

107. *Id.* at 334.

108. See, e.g., Sidel, *supra* note 48, at 34 (“[W]e are left with an important problem. This is the issue of overlapping representation, or conflicts in representation: Can the attorney generals [sic] simultaneously represent prudent investment and diversification principles as well as public benefit as a whole, as well as the interests of a defined community that may be adversely impacted by philanthropic decision-making?”); Brody, *supra* note 59, at 938 (“Importantly, the public served by a particular charity is not necessarily — or even often — the general public. Rather, a given nonprofit serves the indefinite class of beneficiaries chosen by its creators, funders, governing board, and, in some cases, members — but not by the state.”); *id.* at 968 (“Most worrisome, when attorneys general act parochially, no state regulator exists whose interest it is to look out for the beneficiaries of a national or international charity.”)

109. Milton Hershey School, 867 A.2d 674, 686 (Pa. Commonw. 2005).

It held that granting standing to the Alumni Association would “assure judicial scrutiny in situations where important charitable issues are at stake and where the attorney general’s involvement is otherwise lacking, ineffective or conflicted.”¹¹⁰ The Court declined to accept the Attorney General’s argument that his office, rather than the Court, should make the standing determination by balancing the interests of the parties and the community at large:

“In certain circumstances, this balancing of interests will present a conflict of interest for the OAG because certain undertakings of the Trust could affect the community, positively or negatively, but undermine the central purpose of the Trust, which is to help orphan children”¹¹¹

The Court observed, “At bottom, the [Alumni] Association, whose membership consists exclusively of past beneficiaries of the Hershey Trust, is the only other party with sufficient relationship to the Trust that would have any interest in assuring that its charitable purpose was achieved.”¹¹²

Thus, Pennsylvania is now much more flexible than most other jurisdictions in permitting standing to third parties in charitable matters. It follows that the Office of the Attorney General can no longer confidently or quickly negotiate binding agreements with charities because others with a “special interest” may be able to challenge them in court. Charitable institutions will know this, and will be less willing to enter into agreements with the OAG that, like all negotiated settlements, contain some favorable and some unfavorable aspects, because of the risk that a later court proceeding, at the instance of some other player, could result in delays in implementation, litigation expense, and perhaps even court preservation or amplification of the unfavorable aspects of the proposed settlement and modification or elimination of the favorable ones.¹¹³

110. *Id.* at 689.

111. *Id.* at 690 n.27.

112. *Id.* at 690.

113. The dissenting opinion in *Milton Hershey School*, written by President Judge Colins and in which two other Judges joined, noted that “[t]o allow the Alumni Association standing, no matter how eleemosynary its purpose may be, interferes with the effi-

It is ironic that one Attorney General’s political ambitions not only perverted Pennsylvania’s Prudent Investor Rule but in the process also created incentives to move charitable assets outside of his state and weakened the Office of the Attorney General itself.

One can only hope that in due course wiser legislators, judges, and officials will find ways to reverse the damage done to Pennsylvania law by repealing the restrictive amendments to the UPIA, producing a more balanced jurisprudence (overruling or rejecting the excesses in the Orphans’ Court’s opinions), and adopting and embedding more principled administrative practices in the Office of the Attorney General.

Perceptions: Compensation at the Harvard Management Company

Background. The Harvard Management Company (“HMC”) was founded in 1974 to provide management for Harvard University’s endowment, pension, assets, working capital, and trusts.¹¹⁴ The traditional way for universities to manage endowment funds is through the use of outside fund managers specializing in different asset classes; each manager is given a portion of the endowment to manage.¹¹⁵ In contrast, Harvard has managed most of its assets internally since the founding of HMC.¹¹⁶

In 1990, Jack Meyer arrived to head up HMC. He was faced with an asset allocation that had a smaller weighting in equities and a larger weighting in cash and private investments than comparable institutions.¹¹⁷ Meyer set about the task of establishing a “policy portfolio” — a long-term asset mix that would balance Harvard’s tolerance for risk against its need for long-term endowment returns.¹¹⁸ After extended analysis using portfo-

cient performance of the Attorney General’s statutorily-mandated duties” 867 A.2d at 692.

114. Harvard Business School Case Study, Harvard Management Company (2001), October 23, 2001 [hereinafter Case Study 2001].

115. Joseph Nocera, *Punishing Success At Harvard*, N.Y. TIMES, Oct. 22, 2005 at C1.

116. Case Study 2001 at 3. Currently, about one-half of the endowment assets are managed internally. See Nocera, *supra* note 115.

117. Case Study 2001 at 2.

118. *Id.* at 2-3.

lio theory, a policy portfolio was established. This portfolio is reviewed regularly by the HMC Board and at least annually by the Board of the Harvard Corporation (the University's operational governing body) and when appropriate is modified accordingly.¹¹⁹

This policy portfolio specified the “neutral weightings” for each asset class, but HMC could make tactical asset allocation bets within a minimum and maximum range.¹²⁰ Specifically, there were two ways for HMC to outperform the policy portfolio: either they could make successful tactical asset allocation decisions, or they could outperform the benchmarks for an asset class.¹²¹ Meyer believed that HMC had no particular advantage with respect to tactical asset allocation, so he instead focused his staff's energy on detecting and capturing pricing inefficiencies within asset classes.¹²² In this sense, HMC operated more like a hedge fund than a conventional money management firm.¹²³ Indeed, it was not unusual for the fund to be “long” as much as three times its net value and “short” as much as two times that value.

Meyer's strategy proved a success: in the ten-year period ending in 2001, the annual return on Harvard's endowment was almost 17 percent, while the annual median performance of large institutional funds was approximately 11 percent.¹²⁴ Harvard's endowment is by far the largest of any university's: in 2004 its fair market value exceeded \$22 billion,¹²⁵ and today it exceeds \$25 billion.

119. *Id.*

120. *Id.* at 3.

121. *Id.*

122. *Id.* at 3.

123. Harvard Business School Case Study, Incentive Pay for Portfolio Managers at Harvard Management Company, December 15, 2003 [hereinafter Case Study 2003].

124. *Id.*

125. Karen W. Arenson, *Markets Help Endowment Pass \$22 Billion at Harvard*, N.Y. TIMES, Sept. 16, 2004 at A23. It is important to note that Harvard's endowment is not a single entity; rather, it consists of over 9,600 funds donated over the last three hundred years. While at most universities, the president controls the endowment, the endowment funds at Harvard belong to whichever of the ten schools they were donated. This system has resulted in a wide disparity in wealth amongst the schools: the Faculty of Arts and Sci-

The incentive pay structure. In order to align fund performance with manager pay,¹²⁶ Meyer developed an objective compensation system for fund managers that consisted of three main components: a base salary, a “neutral” bonus, and an incentive bonus.¹²⁷ The incentive bonus was a multiple of the fund return (net of expenses) less the return on the benchmark.¹²⁸ This number could be positive or negative, but since the neutral bonus could not be reduced below zero, the base salary was the minimum pay in any given year.¹²⁹

Meyer placed two restrictions on incentive bonus — collectively referred to as the “clawed back” component. First, the amount that exceeded a pre-set cap was carried forward and invested in the endowment until the next year.¹³⁰ Second, 30 percent of the incentive bonus (up to the cap) was withheld and invested in the endowment until the following year.¹³¹ In essence, these provisions allowed an extraordinary bonus to be “clawed-back” if the fund performed below the benchmark in subsequent years.¹³² The result was that the incentives of portfolio managers were aligned with those of Harvard — a direct relationship was created between the returns to Harvard and the compensation of the managers.¹³³

ences claims stake to the largest piece of the pie. See Johanna Berkman, *Harvard's Hoard*, N.Y. TIMES MAGAZINE, June 24, 2001 at 39.

126. On the importance of aligning manager compensation incentives with the investor's goals, see the excellent discussion in DAVID F. SWENSEN, PIONEERING PORTFOLIO MANAGEMENT — AN UNCONVENTIONAL APPROACH TO INSTITUTIONAL INVESTMENT 270-72, 278-92 (2000).

127. Case Study 2003 at 2. See Nocera, *supra* note 115.

128. Case Study 2003 at 2.

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.*

133. *Id.* at 2-3. See also Nocera, *supra* note 115 (quoting Scott C. Malpass, manager of Notre Dame's endowment, who characterized Meyer's compensation system as “right

HMC's pay scheme was completely formulaic; there was no component consisting of discretionary bonus based on any subjective evaluation.¹³⁴ However, the system was regularly monitored by the HMC Board, and benchmarks were carefully chosen.¹³⁵ Further, all managers were subject to strict risk controls.¹³⁶

Controversy surrounds bonuses paid. Large returns equal large bonuses paid — such is the mantra that prevails on Wall Street and prevailed at HMC during Meyer's tenure. For example, in 2003, Maurice Samuels, who managed roughly \$1.4 billion in foreign bonds for HMC, made \$35.1 million.¹³⁷ His colleague David Mittelman, who managed HMC's domestic bond portfolio, was paid \$34.1 million.¹³⁸

The flip side of the HMC success story is that these bonuses eventually drew criticism and scrutiny from the Harvard community. The criticism fell into two general categories. First, there were those who simply believed that it was inappropriate for the subsidiary of a nonprofit University to dole out such high wages. Specifically, eyebrows were raised within the nonprofit sector, where pay packages exceeding \$800,000 are considered exceptional.¹³⁹ As Louis R. Morrell, chief investment officer at Wake Forest University, described it: "The culture of the higher-education community has never accepted compensation [that mirrors a Wall Street compensation scheme] and will never accept it, I think, irregardless of whether Harvard continues its practices or not."¹⁴⁰

on"). During Meyer's tenure at HMC, no managers left for a competitor, although several left to set up their own firms. Case Study 2003 at 3.

134. Case Study 2003 at 3.

135. *Id.* at 2.

136. *Id.*

137. See Nocera, *supra* note 115; Stephanie Strom, *Investment Manager to Exit Endowment at Harvard*, N.Y.TIMES, Jan. 12, 2005 at A12.

138. See Nocera, *supra* note 115; see also Strom, *supra* note 137.

139. Stephanie Strom, *Harvard Money Managers' Pay Criticized*, N.Y.TIMES, June, 4, 2004 at A18.

140. Strom, *supra* note 137.

Moreover, even within the universe of university investment managers, the compensation paid at HMC was viewed as comparatively high. In 2003, Meyer was paid \$6.9 million, and the endowment produced a total return after fees and expenses of 12.5 percent.¹⁴¹ Meyer's counterpart at the University of Texas (which had the second-largest university endowment of \$11.2 billion) was paid \$743,316 for producing a 12.8 percent return, and his counterpart at Yale was paid \$1,027,685 for producing an 8.8 percent return on \$11 billion (the third largest university endowment).¹⁴²

The second category of criticism was voiced largely by the alumni base, and it focused more on the choices Harvard was making in spending (or, rather, not spending) its endowment funds. Alumni started to raise concerns regarding the purpose of the Harvard endowment, and the main question was: how big is big enough? Many alumni wanted to know why the university continued to raise tuition and fees, and to supplement student aid packages with loans, when the endowment continued to grow at such a fast pace.¹⁴³

Finally, alumni posited a forceful inquiry: if Harvard can pay money managers so generously, why not do more to supplement the needs of students who cannot afford Harvard tuition? As one alumnus put it, "The managers of the endowment took home enough money last year to send more than 4,000 students to Harvard for a year."¹⁴⁴

In a letter to University President Lawrence H. Summers, members of the class of 1969, in contemplation of their thirty-fifth reunion gift, took exception to the over \$100 million paid to the most highly compensated HMC personnel in 2001 and 2002.¹⁴⁵ The alumni wrote:

141. Strom, *supra* note 139.

142. *Id.*

143. Tuition for the 2004-2005 year at Harvard University was \$27,448, a 5.1 percent increase from the previous year and almost three times the rate of inflation. Strom, *supra* note 139.

144. *Id.*

145. *Extraordinary Bonuses*, HARVARD MAGAZINE, Mar.-April 2004, available at <http://www.harvardmagazine.com/on-line/030422.html>.

If Harvard can afford to pay over \$50 million per year to a small number of financial managers, and if it does so because the endowment has recently experienced excellent growth, it is clear that Harvard can afford to reduce more than \$50 million per year from the ever-increasing cost burden on current students and debt burdens on recent graduates.¹⁴⁶

In effect, the issue of fund manager compensation became blurred with broader issues concerning the overall allocation of the University's resources.

Justifying the bonuses. However inflated the bonuses paid to key HMC personnel may appear to a gentle reader, the University was actually receiving a steep discount as compared to the fees normally paid for outside money management services. It is not unusual for hedge fund managers to earn in excess of \$250 million per year.¹⁴⁷ For example, according to some estimates, Edward S. Lampert of ESL Investments made more than \$1 billion in 2004.¹⁴⁸ Mr. Mittelman's compensation at HMC as a percentage of the money he generated was a fraction of what an outside hedge fund would charge for his services.¹⁴⁹ As C. Dixon Spangler, Jr., a former member of Harvard's board of overseers and onetime president of the University of North Carolina, stated, "[I]f you have the right characteristics for the job, you probably won't want to work for Harvard because the compensation is so much better elsewhere."¹⁵⁰

This notion is ratified in part by the fact that HMC did experience considerable difficulty in finding a replacement for Meyer, who announced in January of 2005 that he would be leaving HMC to start his own investment firm, along with Samuels and Mittelman.¹⁵¹ Of course, much more than compensation was involved. The annual conflict over the compensation amounts created recurring unpleasant friction for many in the HMC of-

146. *Id.*

147. Riva D. Atlas and Stephanie Strom, *Doesn't Anyone Want to Manage Harvard's Money?* N.Y. TIMES, Aug. 5, 2005 at C1.

148. *Id.*

149. Strom, *supra* note 139.

150. *Id.*

151. Stephanie Strom, *Investment Manager to Exit Endowment at Harvard*, N.Y. TIMES, Jan. 12, 2005 at A12. *See also* Atlas and Strom, *supra* note 33.

fices, and those amounts were always made public when Harvard University, as required, filed its Form 990. In addition, there was a general belief that Meyer's successor would have to preside over a changed investment office paradigm, involving much less, or perhaps no, in-house management of the portfolio, and thus would have to oversee the dismantling of much of the HMC structure and the firing or other departure of a considerable portion of its staff.

Ultimately, Meyer agreed to stay on at HMC much longer than he had planned, as it took the university over nine months to find a replacement.¹⁵² His successor is Mohamed A. El-Erian, an emerging markets debt specialist from bond powerhouse PIMCO — a man considered brilliant at managing bonds, but someone who has had no hedge fund experience.¹⁵³ Moreover, HMC recently slightly changed its compensation scheme: compensation for value added was raised, but the pay for high performance staff was capped at between \$20 and 25 million.¹⁵⁴

Costs. At bottom, the controversy about HMC staff compensation involves consideration other than costs to the portfolio. The reactions of faculty, alumni, and others — no matter how well or how poorly founded — are relevant to the operations and management of a university. If some alumni, for example, threatened to reduce their charitable giving to Harvard out of shock at high levels of compensation being paid to HMC personnel, it would behoove the administration to consider whether and to what extent to take such threats into account in making decisions about the management of Harvard's portfolio. Disaffected faculty have the potential to disrupt university processes. Perceptions, in other words, are potentially important here even if not fully in accord with rational appraisals of net value added to the portfolio.

The unique HMC approach involved managing Harvard's funds "in house," an approach followed by no other peer educational institution with even remotely equivalent

152. Atlas and Strom, *supra* note 147.

153. Joseph Nocera, *Punishing Success At Harvard*, N.Y. TIMES, Oct. 22, 2005 at C1.

154. *Id.*

resources. As a result, HMC at its peak employed more than 50 full-time professional managers plus an additional 125 support staff. Two consequences inevitably followed:

- HMC needed to and did attract a significant number of extremely talented staff, which was indispensable to being able to engage in its widely diversified and sophisticated investment strategy, to control overall portfolio risk, and to aspire to produce added value (alpha) over its carefully-selected benchmarks through active management.
- To achieve those goals without undue risk, HMC had to be able to hire and retain staff whose talents made them attractive to many others — including of course many for-profit businesses — seeking portfolio management “stars.”

No doubt, some of HMC’s staff — typically older, experienced, and financially secure from prior career opportunities — were willing to work at HMC for substantially less than what they could have earned elsewhere because of the psychic and other satisfactions of being employed by, and thus engaging their talents to benefit, a major charitable educational institution. (One university President has referred to this group as “post-economic.”)¹⁵⁵ To hire, retain, and incentivize a staff of over 170, however, HMC had to deal with those whose finances were not yet secure, whose opportunities were many, and who — unless happily “handcuffed” to HMC — would inevitably be tempted to move to other, much more lucrative positions elsewhere. The “in-house” model, coupled with the enormous size of Harvard’s portfolio, made high — even if not competitively high — compensation packages a *sine qua non*.

It seems clear that this model worked. It worked to produce outstanding returns to the Harvard portfolio, whose performance is the envy of almost all other universities and colleges. It worked to help hire and retain the staff necessary to that task. It also importantly worked to reduce the overall costs of managing the portfolio, because even the high compensation paid to the HMC staff was well below what Harvard would have had to pay to outside managers for similar performance.

155. President John Hennessy of Stanford has used this accurate and amusing label.

Nevertheless, it also seems clear that the “in house” model cannot long continue at Harvard, or perhaps anywhere else for that matter.¹⁵⁶ If that is correct, other models will have to be found and adopted. The standard model for colleges and universities has long been to do little or no hands-on management of securities “in house,” and instead to farm out management to various outside securities, venture capital, hedge fund, and other firms.¹⁵⁷ (This style of management is often referred to as a fund-of-funds approach.) The in-house staff then is usually responsible for asset allocation, risk management, and the selection, hiring, funding, overseeing, and de-funding of the outside active managers. (Of course, in certain asset classes, passive strategies are also frequently used. Particularly in highly-efficient asset classes, buying indices or index funds offers a simple, inexpensive, and attractive method of achieving the desired exposure.) Even if the compensation and other costs of hiring outside managers exceed what might be achievable with an in-house structure, those expenses do not appear on anyone’s publicly-filed Form 990; such “hidden” costs do not attract the same maelstrom of attention that the compensation of in-house managers does.

Even the standard model, however, may be vulnerable to increasing pressures involving compensation. In recent years, portfolio management has become more sophisticated and global, more investors (individual as well as institutional) are seeking alpha through active management, the number of managers has exploded, and the total value of assets moving to “alternative assets” like hedge funds has ballooned. It is no longer common for staff of major endowments (like Harvard and Stanford) to sit in their offices and

156. The Chief Executive Officer of the Stanford Management Company, Michael McCaffery, and two of his top professional staff, announced in December of 2005 that they would be leaving to form their own for-profit management firm. Mr. McCaffery, perhaps like Jack Meyer, concluded that the perception problem and other external forces would, over time, constrain the university from permitting appropriate, albeit high, compensation to be paid to the SMC staff he feels to be necessary to manage, in house, a significant portion of Stanford’s more-than-\$14 billion portfolio.

157. For a quite different method of categorizing various investment office structures, see MARY BARRICK & MELISSA WESTERVELT, INVESTMENT OFFICE ORGANIZATION AND MANAGEMENT (Cambridge Associates 2004). Nothing in that study, however, is necessarily inconsistent with the analysis in the text.

await visits from managers eager to solicit their funds. Instead, staff are required to travel widely, interview many potential managers, and compete for access to the best. In this environment, the skill set of the most talented staff is increasingly valuable and increasingly critical, not only in search of superior investment returns but also in order to control portfolio risk. It is foreseeable that compensation for those talented individuals will be under pressure to rise. If so, even the standard model may begin to encounter the same kind of friction and publicity over high compensation that was responsible, at least in part, for the decline of the in-house model. The result could be the growth of outside for-profit firms, free from the requirement to file public Forms 990, to do some or all of those tasks. In effect, even the in-house work performed under the standard model may begin to be outsourced in whole or in part. It will be interesting to watch developments.

Taken alone, however, the lower cost structure of an in-house model is a compelling advantage. As the RESTATEMENT (THIRD) observed, “[t]he duty to avoid unwarranted costs is given increased emphasis in the prudent investor rule.”¹⁵⁸ By the time of the UPIA, that emphasis had moved from comments to text, i.e., it had become statutorily mandated: “In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.”¹⁵⁹ The UPIA’s comments underscore the importance of this mandate: “Wasting beneficiaries’ money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs.”¹⁶⁰ The most current draft of UPMIFA, dated Feb. 8, 2006, also elevates cost-minimization from comment (as in UMIFA) to mandated statutory rule.¹⁶¹ Thus, it is clear that minimizing costs has become, over time, an increasingly important obligation of charitable fiduciaries overseeing investment portfolios. By switching from a lower-cost in-house model to a higher-cost

158. RESTATEMENT (THIRD) at 6.

159. UPIA § 7.

160. UPIA § 7, comment.

161. UPMIFA § 3(c)(1). The Preliminary Comment to § 3 refers to this as “the duty to minimize costs.”

standard model, and thus incurring the higher fees of outside managers,¹⁶² Harvard’s fiduciaries certainly did not minimize costs. The only justification, then, for “caving in” to the outcries of others is that other institutional values — including, no doubt, fundraising and campus peace — were implicated and outweighed cost minimization considerations. While this is understandable, it does demonstrate how perceptions may overwhelm the dictates of the Prudent Investor Rule.

Pressures: Redrafting UMIFA

Background. In 1972, the National Conference of Commissioners on Uniform State Laws (“NCCUSL”) approved UMIFA. Prior to the promulgation of UMIFA, the governing boards of institutional nonprofits were subject to the investment standards that applied to trustees of private trusts, and investment strategies focused on the characterization of an institution’s assets as income or principal for accounting purposes.¹⁶³ As a result, if an institution was restricted to spending only “income” from an endowment fund, the incentive was for that institution to eschew investments with appreciation potential. Thus, institutions were largely deterred from using modern portfolio theory as an investment strategy.

UMIFA broadened the investment authority of the boards of institutional nonprofits so that a governing board was no longer restricted to investments authorized for trustees. UMIFA permitted the delegation of authority to independent financial advisors, authorized the expenditure of appreciation of investment funds, and provided rules for the release of restrictions on the use or investment of funds. As a result, UMIFA enabled fund managers to use modern investment techniques such as total-return investing and unitrust-style spending.

162. Harvard University will be investing perhaps \$500 million of its endowment with Convexity Capital Management, the for-profit hedge fund that Jack Meyer formed with some of his colleagues. There is no doubt that Harvard’s expenses for managing these assets will go up, despite the special and generous terms Convexity will offer to its mother institution. It has been reported that Convexity has raised over \$6 billion, the most ever for a start-up hedge fund.

163. *Id.*

Overall, UMIFA has been a very successful uniform act. As of 2004, forty-seven jurisdictions had enacted UMIFA.¹⁶⁴ Although variations exist amongst these jurisdictions, the general principles of UMIFA have been almost universally adopted.¹⁶⁵

Problems with UMIFA. Despite the enhanced flexibility in portfolio management made available to institutional nonprofits through the promulgation of UMIFA, problems ensued. For example, UMIFA limited a governing board's expenditure of endowment funds to the increase in value of the fund over the fund's "historic dollar value."¹⁶⁶ HDV is defined by UMIFA as the aggregate fair value in dollars of the following three items: an endowment fund at the time it became such; each subsequent donation to the fund at the time it was made; and each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the fund.¹⁶⁷ The determination of HDV made in good faith by the institution is conclusive.¹⁶⁸ Standards of business care and prudence are also imposed; therefore, UMIFA did not authorize spending down to historic dollar value if that would be imprudent.

The problem with the HDV standard is that it is not indexed to the actual spending power of the amount contributed. Hence, for an older fund that has substantially appreciated, the HDV limitation is meaningless. Conversely, with respect to more recently established funds, the HDV standard together with short-term market declines may preclude the implementation of the modern investment strategies that were the primary rationale for the promulgation of UMIFA. For example, the value of a testamentary gift made by a donor who died in 2000 might have dropped significantly by 2001 (during the fifteen months of estate administration), due to the dot-com bust. Under the HDV standard, the donee is left with two unpalatable options: either invest for growth and halt spending until

164. Memorandum from Susan N. Gary, Reporter for UPMIFA, to National Conference of Lawyers and Corporate Fiduciaries (May 18, 2004) (on file with author).

165. *Id.*

166. UMIFA § 2. Historic dollar value will sometimes hereinafter be referred to as "HDV."

167. UMIFA §1(6).

168. *Id.*

losses are recouped, or invest for and spend only income generated.¹⁶⁹ One comment, circulated by UPMIFA's Reporter to those involved in the drafting process, stated the problem this way:

HDV is fatally flawed because it is neither a function of the passage of time nor a function of the return on investments. Thus, it departs from reality immediately and generally moves ever further away from it. I sympathize with the urge to tether a rule to a fixed point, but any chosen tethering point should have some likelihood of approximating reality. HDV fails that test. We should take courage, however, in the fact that reasonable people — investors, regulators, and judges — can exercise good judgment and be held accountable for bad judgment.¹⁷⁰

In addition to the HDV standard, there were several other problems with UMIFA. To begin, the act was not congruent with the Uniform Prudent Investor Act (UPIA).¹⁷¹ Rather, UMIFA provided a truncated prudence standard for investment decision making, and it did not enumerate all of the relevant factors a charity should consider in making investment decisions (as detailed in UPIA).¹⁷²

Moreover, UMIFA contained several ambiguities. For example, although it implemented the HDV standard, UMIFA failed to provide clear answers to the questions a charity faces when the value of assets drops below HDV.¹⁷³ Likewise, it was unclear under UMIFA whether standards for managing and investing institutional funds should be the same regardless of whether a charitable entity is organized as a trust, a nonprofit corporation, or in some other manner.¹⁷⁴

169. Many advisors believe that UMIFA does not preclude spending from ordinary income, even if the fund value dips below the historic dollar value.

170. Email message from Prof. Harvey P. Dale to Prof. Susan Gary (July 22, 2004) (on file with author).

171. UPIA has been adopted in 42 states and the District of Columbia. UPMIFA Prefatory Note at 1.

172. *Ibid.*

173. UMIFA Prefatory Note at 3.

174. UPMIFA Prefatory Note at 1.

In 2002, a Drafting Committee of NCCUSL began work on a new version of UMIFA. The most recent draft is entitled “Uniform Prudent Management of Institutional Funds Act.” Elimination of the HDV standard is not the only change from UMIFA that the new uniform law would make. According to its Prefatory Note, UPMIFA adds to the statutory language six factors relevant to prudent portfolio management decisions, none of which appears in the statutory language of UMIFA:

- Give primary consideration to donor intent as expressed in a gift instrument,
- Act in good faith, with the care an ordinarily prudent person would exercise,
- Incur only reasonable costs in investing and managing charitable funds,
- Make a reasonable effort to verify relevant facts,
- Make decisions about each asset in the context of the portfolio of investments, as part of an overall investment strategy,
- Diversify investments unless due to special circumstances the purposes of the fund are better served without diversification,
- Dispose of unsuitable assets, and
- In general, develop an investment strategy appropriate for the fund and the charity.¹⁷⁵

The move away from HDV. The current draft of UPMIFA eliminates the HDV standard of UMIFA. In its place is a more carefully articulated standard of prudence that provides detailed guidance for nonprofit institutions.¹⁷⁶ UPMIFA clarifies that in making investment and spending decisions, an institution should attempt to ensure that the value of the fund endures while providing for the spending needs that further the purpose of the endowment.

175. UPMIFA Prefatory Note at 2.

176. UPMIFA § 4.

While the Drafting Committee was comfortable, after the elimination of HDV, relying on prudence as the appropriate standard for spending, several observers and a number of attorneys general have expressed worries over the lack of any ceiling for spending.¹⁷⁷ Concerns were articulated that, without a “bright-line” spending cap, charities might be tempted to spend more than is prudent or might have difficulty fixing a prudent spending pattern.¹⁷⁸ Some advocated the creation of a “safe harbor” for spending, but this idea was rejected by the Drafting Committee.¹⁷⁹

However, in response to these concerns, the current draft of UPMIFA combines the deletion of the HDV standard with the addition of an optional statutory provision creating a “rebuttable presumption of imprudence.”¹⁸⁰ Under this optional subsection, a rebuttable presumption of imprudence is triggered if expenditures in any year exceed seven percent of the value of the assets of an endowment fund. For this purpose, a not-less-than-three-year rolling average is to be used to calculate the value of the fund.¹⁸¹ If endowment spending does exceed seven percent, an institution can rebut this presumption by producing evidence that expenditures above that amount are prudent.¹⁸²

177. Memorandum from Susan N. Gary, Reporter for UPMIFA, to UMIFA Drafting Committee, Advisors, and Observers (Aug. 22, 2005) (on file with author). See also Memorandum from Susan N. Gary, Reporter for UPMIFA, to Drafting Committee and Observers (Nov. 22, 2004) (on file with author); Memorandum from Susan N. Gary, Reporter for UPMIFA, to Drafting Committee (July 16 2004) (on file with author); Memorandum from Susan N. Gary, Reporter for UPMIFA, to Drafting Committee (May 25, 2004) (on file with author); Memorandum from Susan N. Gary, Reporter for UPMIFA, to UMIFA Drafting Committee (Oct. 20, 2003) (on file with author) (all detailing comments received over the lack of a bright-line spending rule).

178. *See supra* note 164.

179. *Id.*

180. *Id.*

181. UPMIFA § 4(d).

182. The concept and language in this section are taken from Mass. Gen. L. ch. 180A, § 2 (2004). Massachusetts enacted this law as part of its UMIFA statute in 1975, and New Mexico adopted the same presumption in 1978. See N.M.S.A. § 46-9-2 (C) (2004). The current draft of UPMIFA clarifies that the three year period applies to the three years immediately preceding the year of the expenditure. UPMIFA cmt. § 4.

To signal that the presumption is optional, the relevant statutory language is bracketed. According to the preliminary comment to the current draft, while “prudence will dictate the amount an institution should spend, a state may choose to adopt [the rebuttable presumption of imprudence] as part of UPMIFA.”¹⁸³

The rebuttable presumption. The concerns of those wishing to substitute a 7%-spend-rate presumption of imprudence, as a trade-off for the repeal of the HDV rule, are probably two:

- Some Attorney Generals’ staff desire a bright-line test to make it easier for them to intervene to deter over-spending, and
- Some banks and trustee institutions desire a bright-line test to make it easier for them to decline pleas for more funding from beneficiary charities.

These are both understandable. Adoption of the presumption should, however, be opposed because UPMIFA will be a better statutory standard if HDV is eliminated without the creation of a new, mechanical test that lacks nuance, adds complexity, and isn’t consistent with modern portfolio practices.

The reasons for repealing the HDV rule have already been discussed, above. The new 7% presumption is also unwise for both technical and policy reasons. On the technical side:

- The calculation of the value of the fund, against which the 7% is to be applied, is to be made “on the basis of market values determined at least quarterly and averaged over a period of not less than three years immediately preceding the year in which the appropriation for expenditure is made”¹⁸⁴ Thus, at a minimum, the computation will involve collecting data for 12 valuation points. The comments, happily, state that “[t]he period a charity uses to calculate the presumption (three or more years) and the frequency of valuation (at least quarterly) will be binding in

183. *Id.*

184. UPMIFA § 4(d).

any determination of whether the presumption applies.”¹⁸⁵ At least that means that a charity won’t be faced with a potentially different value calculated by an angry Attorney General on the basis of different periods and different sampling frequencies. Nevertheless, a charity wishing to spend at a high rate — and anxious to know what range of spending it might safely undertake — may be put to the task of calculating not one but several (or many) alternative valuations using different periods and different sampling frequencies. Some of these calculations might require gathering data for many more than 12 valuation points. If the portfolio is substantial, each valuation point may require determining hundreds or thousands of individual security values, including values for holdings that are illiquid.¹⁸⁶ It is hard to believe this potentially massive effort will be worth the cost.

- The presumption is rebuttable. The comments elucidate that, if it is triggered, “the institution will have to carry the burden of production (i.e., the burden of going forward with) other evidence that would tend to demonstrate that its decision was prudent. The existence of the presumption does not shift the burden of persuasion to the charity.”¹⁸⁷ In most cases, it will be fairly easy for a charity to introduce some scintilla of evidence to carry its burden of production, following which the presumption falls away.¹⁸⁸ On the one hand, this means the presumption has very little value for the regulators who wanted a bright-line test; on the other, it makes one wonder why the computational effort should be imposed on a charity in the first place. If the presumption doesn’t help much but nevertheless imposes burdens

185. UPMIA § 4, comments at 28.

186. Consider the difficulty and cost of obtaining a minimum of 12, and perhaps many more, appraisals of various real estate holdings, venture capital investments, hedge funds, etc., located all over the world.

187. UPMIFA § 4, comments at 28.

188. This may somewhat assuage the anxiety of charities’ staff and officers, but familiarity with the charitable sector makes the author believe that it will not assuage it sufficiently for them to ignore the presumption and dispense with the calculations.

on charities, a proper weighing of the cost-benefit considerations should suggest that it not be adopted.

As a matter of sound policy, it hard to see why special statutory concern should be expressed about too much, rather than too little, expenditure for charitable purposes. All are aware of the 5% minimum distribution rules applicable to private foundations.¹⁸⁹ Recent heated debates, on the federal level, have focused on whether those rules should be tightened in order to promote more current distributions. Why, then, should a uniform law at the state level try to crimp spending at 7%? The only apparent answer is to protect “donor intent.” It is beyond the scope of this paper to explore the anfractuons arguments bearing on how best to balance fealty to donor intent against appropriate flexibility to meet new and unforeseen circumstances; the papers presented at a recent two-day conference on the subject provide some useful analyses.¹⁹⁰ Many people, including the author, believe that the risks flowing from overly-rigid adherence to a donor’s intent exceed the risks arising from charitable spending frolics the donor would have disliked. The issue at stake here does not involve diversion of charitable funds from purposes established by the donor — the risk of faithless misdirection of funds has not been raised. Rather, the only question is the pace at which funds are expended for the purposes concededly contemplated by the donor. Furthermore, the rule of prudence remains sovereign: spending at a rate less than 7% may be imprudent, as the UPMIFA comments clearly state,¹⁹¹ just as spending at a rate of 7% or more may be prudent.

“Donor intent” may be thought of as having three different aspects: substantive, temporal, and procedural. Consider, for example, a donor, D, who gives an endowment fund to university X for student scholarships. The substantive intent is to benefit needy

189. I.R.C. § 4942

190. The conference, held Oct. 27-28, 2005, under the auspices of the National Center on Philanthropy and the Law, was entitled, “Grasping the Nettle — Respecting Donor Intent and Avoiding the ‘Dead Hand’.” In due course, the papers will be available on the web site of the NCPL.

191. UPMIFA § 4, comments at 28 (“Expenditures at six percent might well be imprudently high.”)

students; the temporal intent is for the fund to last in perpetuity; the procedural intent is for X to exercise its discretion in taking care of all of the details, e.g., investing the fund, deciding on the criteria and financial formulae for student eligibility, selecting the particular students to receive scholarships, etc. Importantly, the debate about whether to adopt the rebuttable presumption, just like the debate (now resolved) about repealing the HDV rule, does not involve substantive intent: all parties assume that X will faithfully use the fund for student scholarships. The debate is only about D's temporal intent. Interestingly, little or no attention has been paid to D's procedural intent. After all, D selected X to make many implementing decisions, and obviously chose to trust X to make and modify them in perpetuity. Those decisions will all have meaningful impact on the implementation of D's wishes. If D has expressed D's procedural intent by expressing such confidence in X, why should the statute pick out D's temporal intent as requiring special attention? The overall prudence standard still applies; the drafters of UPMIFA explicitly stated, and the author agrees, that this standard is both "appropriate and *adequate*."¹⁹²

For all of these reasons, it is possible that the presumption will not be enacted by all states. Because the presumption is optional, each state will be required to decide whether to adopt it. It is to be hoped that most will choose not to do so. The pressures in favor of a bright-line mechanical test should be resisted, the prudence standard should be relied on as both appropriate and adequate, and the burdens and technical problems that would follow from adoption of the presumption should be avoided.

Next steps for UPMIFA. The UPMIFA Drafting Committee had its last official meeting the weekend of January 21, 2006. At that meeting, representatives of states' attorney generals continued to voice concerns about the elimination of the HDV standard. However, their concerns focused on small charities and endowments. Accordingly, the Drafting Committee added a "notice provision" in the comments accompanying the statute.¹⁹³ The notice provision provides that if a charity has aggregate funds of less than \$2

192. UPMIFA Prefatory Note at 5 (emphasis added).

193. UPMIFA § 4, cmt.

million,¹⁹⁴ and the charity wants to make an expenditure that will take funds below HDV, the charity must notify the attorney general and give the attorney general sixty days to respond. This gives the attorney general an opportunity to meet with the charity or take other appropriate action. Because this is only a notice provision, however, attorney general permission is not required for the charity to make the expenditure.

The Drafting Committee is currently awaiting feedback on the new rebuttable presumption of imprudence.¹⁹⁵ The latest draft will be up for a final review and approval by the commissioners comprising the NCCUSL in early July 2006. Assuming the commissioners approve the draft, UPMIFA will be official as of that vote (superseding UMIFA), and a final draft will be promulgated late summer or early fall of 2006. It will then go to the states for adoption.

Conclusion

The law's learning about prudent investing has proceeded perhaps too slowly since the publication of Harry Markowitz's insights in 1952. Nevertheless, by the end of the 20th Century the law for the most part reflected and embraced Modern Portfolio Theory, although more remains to be done to complete the task. It would be sad indeed if politics, perceptions, or other pressures now began to pervert the Prudent Investor Rule. The instances discussed in this paper are, hopefully, exceptions to the otherwise generally good progress. Still, vigilance will no doubt be required.

194. Unfortunately, the \$2 million figure is not indexed and thus will inevitably become too small with the passage of time.

195. Terry Knowles, an assistant attorney general from New Hampshire involved in the UPMIFA drafting process, plans to meet with the National Association of State Charity Officials to gauge their feedback on the current draft.