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MARCH 2003

# 1 Investment Standards of Charities

## INVESTMENT STANDARDS OF CHARITIES

Everyone worries about investments, and trustees and boards of directors doubly so because investment decisions are among their most important responsibilities. In recent years, a number of legal developments, including the Prudent Investor Rule, the Uniform Management of Institutional Funds Act (“UMIFA”), and the Uniform Principal and Income Act, have influenced how trustees and directors make investment decisions.

This issue of *Professional Notes* focuses on investment concerns of charitable organizations, whether organized in corporate form or under trust law. Because different standards apply based upon the form of organization, the implications of these standards should be considered by any practitioner advising a client about creating a charitable organization.

The Prudent Investor Rule, found in New York Estates, Powers & Trusts Law (“EPTL”) §11-2.3, took effect in New York in 1995. The rule did not eliminate trustees’ liability for investment of trust assets, but changed the nature of investment responsibility so that the focus is now on overall portfolio strategy rather than on individual

investments, bringing the law more into line with modern investment theory.

A variation of the Prudent Investor Rule is embodied in the New York Not-for-Profit Corporation Law (“NPCL”). Less detailed than the provision relating to trusts and estates, NPCL §717 mandates that “directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.”

## STANDARDS FOR TRUSTEES AND EXECUTORS

*New Standard Supercedes “Prudent Man Rule.”* Under New York’s former “prudent man rule,” the appropriateness of each investment was determined separately. If an executor or trustee bought an asset and it decreased in value, it could have been considered an imprudent investment even if the overall portfolio did well.

The Prudent Investor Rule makes it clear that there are no investments that are inappropriate or imprudent *per se*; it stresses the investment of the entire fund, as opposed to each individual asset, and the conduct of the fiduciary rather than the performance of the portfolio. The executor or trustee

is expected to “exercise reasonable care, skill, and caution to make and implement investment and management decisions as a prudent investor would for the entire portfolio taking into account the purposes and provisions of the governing instrument.” EPTL §11-2.3(b)(2). As described below, he or it must pursue an investment strategy that takes into account the particular circumstances of the trust and its beneficiaries, the appropriate level of risk, and the probable effects of inflation.

***Factors To Be Considered.*** An executor or trustee must pursue an overall investment strategy designed to enable him to make “appropriate” present and future distributions to the beneficiaries. Rather than enumerate acceptable investment programs (as New York law did prior to 1970), the statute sets forth a non-exclusive list of factors to be considered in devising an investment strategy including:

- the size of the portfolio
- the nature and expected duration of the trust or estate
- liquidity and distribution requirements of the governing instrument
- general economic conditions
- the possible effect of inflation or deflation
- the expected tax consequences of investment decisions or strategies and of distributions of principal or income to the beneficiaries
- the role that each investment plays within the overall portfolio
- the expected total return of the portfolio from both income and appreciation of capital
- the present and future distribution needs of the beneficiaries, to the extent reasonably known to the trustee

Related trusts, the beneficiaries’ other assets and resources, and the special value of particular assets to one or more of the beneficiaries are other circumstances that may be taken into account.

***Executors’ Strategies May Differ.*** Executors of estates also are subject to the requirements of the new law, but its effect on them may be different than on trustees. Because of the expected short duration of an estate, an executor may determine that there is no need to diversify. Or he may create a conservative portfolio designed to preserve the estate assets and seek little or no growth. However, where the estate’s assets subsequently will be held in trust under the will, the executor may want to anticipate the risk and the return objectives of the trust to be funded.

***Diversification.*** Under the former rule, a fiduciary was under no duty to diversify investments unless, in a given situation, prudence required diversification. The new rule establishes a strong presumption in favor of diversification: the trustee must diversify the trust’s portfolio unless he determines that the purposes and terms of the governing instrument do not require it and it is in the beneficiaries’ best interest not to do so.

Moreover, the fiduciary is required to determine within a reasonable time whether to retain or dispose of the initial assets held by the trust or estate.

***Effect of Inflation.*** Under the old rule, there was no requirement that a fiduciary invest assets to protect the principal from erosion by inflation. The new rule identifies the probable effect of inflation as a key factor to be considered. As a result, it generally will be necessary to be able to show that the investment strategy was designed to achieve reasonable principal growth.

Fiduciary duty will no longer be fulfilled by traditional “capital preservation”—maintaining the same dollar value of a trust. If a portion of the portfolio is to be invested in bonds or other fixed-income securities that do not appreciate in value over time, the strategy probably should include a

means of counteracting the erosion of the purchasing power of that portion.

**Appropriate Level of Risk.** The trade-off between risk and return may be the trustee's most difficult task. The fiduciary must determine the appropriate level of risk that conforms to the objectives of the trust and will also meet any distribution requirements that the will or trust agreement has imposed. Since the trustee or executor is charged with the obligation at least of preserving the real value of the portfolio, he generally must take at least as much risk as is necessary to prevent inflation from eroding the value of the fund as a whole.

In determining the appropriate allocation of the portfolio among the categories of investments for a trust, the fiduciary will have satisfied the requirement of considering the "market" risk. In theory, at least, returns correlate with risk in each investment category; the more volatile the type of investment, the greater the potential return on the investment. However, the appropriate degree of risk varies with the purposes of the trust and the needs of the beneficiary. As noted in the 1994 Report of the National Conference of Commissioners on Uniform State Laws, a program set up by the trustee of a trust for an elderly beneficiary with limited resources would be very different from that of a trustee of a discretionary trust for a minor who is supported by his or her parents.

In addition, there is risk that is unique to each particular asset and is not compensated for by the market. The market may rise over time, but the value of a particular stock or an industry can be depressed for reasons unique to that company or industry. As noted above, the new law emphasizes the need to protect the portfolio from this risk by diversifying the investments. An exception might be a trust specifically designed to hold a closely held business interest.

**Investment for Total Return.** The new law encourages trustees to focus on total return from both ordinary income and capital appreciation. The "total return" concept allows greater investment latitude in the case of an instrument that gives broad discretion to pay or accumulate income and to distribute principal to the beneficiary.

However, this spur to total return may have little practical effect if the governing instrument of the trust strongly preserves the distinction between principal and income. For example, if the purpose of a trust is to provide support for the beneficiary, and all the income must be paid to the beneficiary with no or limited principal invasion provision, the trustee cannot ignore the beneficiary's need for income (generally interest and dividends) and invest exclusively in growth securities, even though they might produce a greater total return. (The impact of the Uniform Principal and Income Act on this distinction is the subject of a future issue of *Professional Notes*.) Similarly, if the trust is to qualify for the marital deduction and is required by Federal tax law to pay all of its income to the surviving spouse, it will be necessary to continue to focus on the production of ordinary income.

**Delegation.** A significant change brought about by the Prudent Investor Rule permits a trustee to delegate discretionary investment authority to an investment advisor. However, in delegating investment authority, the trustee must exercise "care, skill and caution" in:

- selecting a suitable advisor, taking into consideration the delegated functions, the nature and value of assets involved, and the advisor's expertise;
- establishing the scope and terms of the delegation, consistent with the purposes of the governing instrument;
- periodically reviewing the advisor's exercise of the delegated function and compliance with the terms of the delegation; and
- controlling the overall cost of the delegation.

The investment advisors themselves become liable as fiduciaries in the investment process as a result of the delegation, and *both* the investment advisor and the trustee are liable for the agent's decisions concerning the investment of trust assets. Any attempted exoneration from or limitation on liability is void as against public policy.

EPTL §11-2.3 (b)(5) requires a fiduciary with special investment skills (i.e., the professional trustee) to exercise those skills and provides that performance will be judged accordingly. This suggests that a trustee that holds itself out as having special skills may not delegate authority to another except in areas outside the trustee's expertise.

***Varying the Rules.*** It is important to bear in mind that the Prudent Investor Rule is a default provision and applies only to the extent that the terms of the governing instrument do not provide otherwise. Other standards or guidelines may be prescribed, provided they are not contrary to public policy.

The draftsman may want to provide investment guidance to the trustees by stating the primary purpose of the trust in the instrument. For example, an instrument could require that a trust be invested to provide maximum income and safety, regardless of the impossibility of growth and the resulting likelihood that the real value of the principal will be diminished by inflation, or it might emphasize growth for a child who has limited need for current income. Or the instrument might provide that diversification is unnecessary and assets transferred to the trust have special importance to the grantor.

***Documenting Procedures.*** A trustee or executor will need to ensure compliance with the provisions of the new law. He should determine and document the objectives of the trust, the investment strategy designed to meet those objectives, and the procedures to be followed in pursuit of that strategy.

## NOT-FOR-PROFIT CORPORATIONS

Directors of a not-for-profit corporation are not trustees, although the terms "director" and "trustee" are sometimes used interchangeably. Nor is the corporation somehow a "trustee" with respect to its assets. The New York Not-for-Profit Corporation Law specifically provides that a charitable corporation is not a trustee of assets given to it. NPCL §513(a).

The Uniform Management of Institutional Funds Act ("UMIFA") which has been adopted, with some variations, in most states including New York, governs investment and endowment spending. The standard of care for directors of nonprofit corporations is based upon corporate law's business judgement rule and differs from the standard for trustees in several ways.

NPCL §717 mandates that "directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." Unlike Trust law, the emphasis in corporate law is on "ordinarily prudent *men*," not the "prudent *investor*."

***Factors to be Considered.*** In investing assets and delegating investment management, the board is charged with considering, among other relevant considerations:

- the long- and short-term needs of the corporation in carrying out its purposes
- its present and anticipated financial requirements
- expected total return on investments
- price level trends
- general economic conditions

As with trustees, there are no restrictions on the types of investments a board may make (subject to limitations in the gift instrument). New York law provides that the governing board may invest in any

real or personal property it deems advisable, including mortgages, stocks, bonds, debentures, and interests in partnerships, and pooled or common investment funds (such as mutual funds or REITS), whether or not it produces a current return. NPCL §512.

**Diversification.** New York law also does not specifically mandate diversification, and NPCL §512 authorizes the governing board “to retain property contributed by a donor . . . for as long as the governing board deems advisable, taking into account any request by the donor to do so.” However, “prudence” generally is understood to require diversification, subject, of course, to the terms of the gift instrument.

**Investment for Total Return.** Although investment for total return is not explicitly mandated, UMIFA as adopted in New York requires a board to consider total return when it makes investment decisions and when it wishes to spend capital appreciation. Federal tax law adds an interesting wrinkle here: regulations governing private foundations (Treas. Reg. §53.4944-1) effectively require investment for total return, viewing investment decisions within the context of the entire portfolio.

**Delegation.** UMIFA expressly authorizes a charity’s governing board to delegate investment decisions either to a committee of the board, or to outside investment advisors. Unlike the trust law rule, the board may rely upon the agent’s decisions, provided the board exercised the requisite standard of care in selecting the agent. NPCL §514.

## CONCLUSION

As is always the case with a comprehensive new statute such as the Prudent Investor Rule, its enactment has introduced areas of uncertainty that will remain until the courts interpret its provisions.

Although UMIFA has been embodied in New York’s Not-for-Profit Corporation Law for many years, it, too, is relatively untested. UMIFA currently imposes a standard of care on directors that is more flexible than that imposed on trustees. If enacted, a recent draft of an amended UMIFA, dated October 20, 2002, would bring UMIFA sharply into line with the trust law’s prudent investor standard, as described above.

With these uncertainties in mind, a trustee or a board of directors of a not-for-profit corporation may want to seek professional advice to meet the requirements of the applicable law and take full advantage of the opportunities it may present. The differences in the standards imposed on trustees and boards of directors also should be taken into account when helping a client create a charitable organization and determine whether it should be set up in trust or corporate form.

### For further reference, see:

EPTL §11-2.3

NPCL §102

NPCL §§512-514

NPCL §522

NPCL §717

J. Blattmachr and S. Polk, *A Practical Look at the Prudent Investor Rule*, The Chase Review October 1995

E. Brody, *The Limits of Charity Fiduciary Law*, 57 Md. L. Rev. 1400 (1998)

Proskauer Rose Goetz & Mendelsohn, *Personal Planning Strategies*, November 1994

*Uniform Prudent Investor Act*, drafted by the National Conference of Commissioners on Uniform State Laws (1994)

S. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 Hawaii L. Rev. 593 (1999)

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