

Chapter Six

ENDOWMENT AND DEVELOPMENT

There are legal, contractual, and moral responsibilities that apply to obtaining and managing an endowment. State law plays a critical role since most states have adopted the Uniform Non-profit Corporation Act. Many states have also adopted the Uniform Management of Institutional Funds Act (UMIFA). Both of these statutes contain standards by which fiduciary decisions of trustees and directors are assessed and evaluated.

I. Endowment Policy

Critical to the fund raising enterprise is the development of a university policy that deals with gifts and gift giving. When tough decisions concerning such issues as acceptance or rejection of a gift or the need to obtain releases of liability for potential exposure must be made, it is important to be able to rely on a sound endowment policy.

When auditing the institution's development policy, the key questions to ask are :

- ◆ Who has the authority to receive a gift?
- ◆ What types of gifts will be accepted?
- ◆ What types of restrictions will be permitted on endowment funds?

- ◆ What is the policy on receiving certain types of gifts, such as land, that can create environmental liability?
- ◆ What is the policy on providing appraisal statements for certain gifts of property?
- ◆ What minimum amounts are required for particular gifts?
- ◆ What is the policy on gifts such as charitable remainder trusts and other deferred gifts?

II. Donor Rights and Privacy

Donors have rights that should be protected by the institution. These include the right to have personal information kept private. This may be legally required and is also necessitated by ethical considerations and the need to establish productive donor relations.

Critical concerns in this area focus on the dissemination and collection of data on potential or actual donors. Acquisition may involve intrusive inquiries. The careless dissemination of information leading to the involvement of persons who do not need to know about a particular donor's net worth or capacity to give can create great harm and potential liability.

The Council for the Advancement and Support of Education (CASE) has developed a series of guidelines regarding donor privacy and ethical consideration.

When auditing the institution's donor privacy policies, the key questions to ask are :

- ◆ Is there a policy on the disclosure of personal information that should not be made public?
- ◆ Is there some limitation on the scope of donor research so that it is limited to the individual and the capacity or inclination to make a gift to the institution?
- ◆ Is there a policy on access to donor information with

guidelines for determining who has a legitimate need to know such information?

- ◆ Is there a policy limiting the sharing of donor information with other institutions?
- ◆ Is there a policy on what type of information is recorded on a donor's records so that defamatory and inaccurate material is not retained?

III. Endowment Management

Trustees and directors have legal duties related to the oversight of the management of the endowment. They must exercise due care and loyalty and make decisions on the basis of the “prudent” standard in managing and monitoring endowment performance.

This duty has taken on new meaning as institutions leverage their endowments by investing in new businesses or other nontraditional venues. Board members or officers of the institution may also own some interest in these more speculative ventures. Such situations can create legal conflicts of interest or at least call into question the exercise of the duties of care and loyalty to the institution.

Trustees must avoid both conflicts of interest as well as the appearance of a conflict. Accordingly, any potential conflict must be disclosed. In the area of endowment management, such a conflict might occur through investment decisions or in the selection of the providers of investment management or other custodial services.

The leading case defining the responsibilities and duties of directors is the Sibley Hospital (1974) decision. In that widely followed and quoted ruling, the court responded to claims of mismanagement and conflict of interest when it ruled that a trustee or director must “use due diligence in supervising the action of those officers, employees, or outside experts to whom the

responsibility for making day-to-day financial or investment decisions has been delegated.” Further, the court ruled that “a director who fails to acquire the information necessary to supervise investment policy or consistently fails even to attend the meetings at which such policies are considered has violated his fiduciary duty to the corporation.”

When auditing the institution’s management of its endowment, the key questions to ask are :

- ◆ Who has the authority to make investment decisions?
- ◆ Who hires the investment counsel or managers?
- ◆ How is the performance of the investment managers assessed?
- ◆ How frequently is the investment performance evaluated and monitored?
- ◆ What is the policy regarding the types and percentages of investments that can be made?
- ◆ What is the policy for establishing the degrees of risk that the managers can assume or obligate?
- ◆ What is the spending policy?
- ◆ What is the policy and the law on the allocation and use of capital gains?
- ◆ Have state laws such as the Uniform Management of Institutional Funds Act been reviewed to determine the precise limits and range of authority in certain investment decisions?
- ◆ If there is an endowment policy on encumbering the endowment, and if the endowment has been pledged in any manner, has the institution obtained a legal opinion on the pledge of the endowment?
- ◆ Do governing decision makers understand the prudent person rule and what it means for making endowment decisions?

The appendix contains a checklist of questions about endowment management and a sample endowment policy and a sample spending policy.

IV. Charitable Solicitation Laws and Disclosure Requirements

Most states have adopted charitable solicitation laws with which colleges must comply. The laws are designed to protect consumers from excessive puffing of charities' worth. These laws inform consumers of the basic mission of the charity and the charities' administrative costs. The regulations, however, are directed primarily at independent fund raising consultants and paid solicitors, rather than at fund raisers employed by institutions.

In most cases, educational institutions are exempted from these laws. However, college and university administrators must be aware of their applicable state laws that cover fund raising.

Due to the publicity of some large scale charitable mismanagement, there is mounting pressure to increase charitable accountability. Further, the misuse of 501(c)(3) nonprofit organizations for political purposes has fostered increased scrutiny.

In auditing an institution's charitable solicitation activities, the key questions to ask are :

- ◆ Is the institution exempted or must it comply with state charitable solicitation statutes?
- ◆ Does the institution have an exemption from filing or from registering under the statutes?
- ◆ Are there other consumer laws requiring disclosure of solicitation expenses for major fund raising campaigns applicable to the institution?
- ◆ Does the institution know what it costs to implement annual fund raising or other major gift campaigns?

- ◆ Does the institution have a procedure for handling requests to review the institution's nonprofit income tax return, Form 990?
- ◆ Do Form 990 review requests establish to whom and how such requests should be made along with costs related to obtaining the return?
- ◆ Does Form 990 accurately reflect the compensation, including fringe benefits, of the officers for which the institution must report?

V. Alumni Clubs

Alumni clubs are generally considered an integral part of the overall advancement program. Initially, most alumni clubs were directly related to the advancement function and did not have any separate legal status. In light of the interest of alumni clubs in raising funds, controlling those funds, and possessing greater autonomy, some alumni clubs seek a separate legal existence. Furthermore, some institutions encourage separate incorporation in order to protect the institution from liability. Regardless of their legal status, it is important that the institution know what is happening with the alumni clubs. The institution should be aware of who is soliciting money and what commitments the clubs are making.

When auditing the institution's alumni clubs, particularly those that are separately incorporated, the key questions to ask are :

- ◆ Who hires the employees and determines other employment matters?
- ◆ Are the employees required to take direction from the university, particularly its advancement office?
- ◆ Who does the accounting and how?

- ◆ Are gifts passed directly to the university or are they retained by the alumni club?
- ◆ If gifts are retained by the alumni club, for what purposes may they be used?
- ◆ Does the institution have any obligation to pay the bills of the alumni club?
- ◆ Who purchases insurance for the activities of the alumni club?
- ◆ Does that insurance cover employees of the university when they act on behalf of the alumni club?
- ◆ If a coordinated capital campaign is developed, is the role of the alumni club clearly established?

VI. Taxation and Substantiation of Gifts

The nonprofit status of colleges and universities produces two major benefits. First, the income of the college is not subject to taxation unless it is characterized as unrelated business income. Second, gifts to the college from donors are tax deductible, driving many large charitable gifts to colleges and universities.

There are responsibilities that go along with being a tax-exempt organization. One of those limitations relates to political and lobbying activity. There are also reporting requirements mandated for all gifts in kind or in cash in excess of \$250.00. Further, there are more specific requirements when gifts of certain property in excess of \$5,000 are donated to the college.

Specifically, there are definite thresholds and substantiation requirements that apply to charitable contributions and to the treatment of quid pro quo contributions that must be followed by the institution.

The basic principle on charitable contributions is: “A deduction is not allowed for a payment to charity in consideration for goods or services except to the extent the amount of the payment exceeds the fair market value of the goods or services.” It is

incumbent upon the institution to determine how to value a quid pro quo contribution. When making certain gifts, donors may receive benefits such as recognition events, dinners, access to athletic events or club facilities and parking, all of which must be valued by the institution.

There are benefits of “insubstantial value,” that do not need to be reported to the donor. It is important for the institution to establish how it will value these benefits and to make sure it complies with the substantiation rules.

Furthermore, gifts made to universities must not directly benefit the donor. For example, a donor cannot give a deductible scholarship to the institution that solely benefits the donor’s children.

In auditing an institution’s taxation and substantiation responsibilities, the key questions to ask are :

- ◆ Does the institution have a definite procedure for acknowledging all gifts, particularly those that must be acknowledged pursuant to the Internal Revenue Service requirements?
- ◆ Does the institution have a procedure that ensures that benefits received by donors are properly substantiated?
- ◆ Does the institution have a policy regarding the appraisal of gifts “in kind”?
- ◆ Does the institution make it clear that while it may advise donors on certain tax consequences of gift giving, the donor is responsible for obtaining their own tax advice?
- ◆ Does the institution review all major gifts to ensure that they are of a legally acceptable charitable nature?

VII. Enforcement of Donor Gifts

Generally, donors make pledges that bind the donor while institutions make commitments and undertake obligations in light of the donor commitment. The institution may have to confront the problem of nonpayment of the donor's pledge. There is widely accepted case law that, under certain conditions, the college or university has a legal right to enforce a donor commitment, particularly when the institution has taken steps toward implementing the purpose of the gift. Obviously, whether to bring a lawsuit or to threaten legal action is a policy judgment for the institution. A widely followed case involved a donor who attempted to revoke a gift and who relied on the Uniform Management of Institutional Funds Act as a legal basis for the donor challenge. (*Herzog Foundation v. University of Bridgeport* (1997)).

Enforcement of gifts has become an increasing problem in light of the new accounting standards related to accounting for an irrevocable pledge.

In auditing an institution's enforcement of donor gift responsibilities, the key questions to ask are :

- ◆ Are gifts properly reported for audit purposes as required by the new audit guidelines applicable to nonprofit institutions?
- ◆ Before making commitments for certain obligations, has the institution fully satisfied itself that the donated funds will, in fact, be available?
- ◆ Does the institution have a policy or procedure for enforcing the donation of major gifts that become delinquent or remain unpaid?

VIII. Affiliated Foundation Agreement

Some institutions choose to establish foundations that are controlled internally. Others desire to establish foundations independent of the institution. In general, foundations are established in order to obtain new sources of revenue and for operational efficiencies. Separate entities may attract board members who would not otherwise serve on a board controlled by the institution.

For public institutions, obtaining exemption from open meeting and open records laws may also form the catalyst for the formation of an affiliated foundation. Exemptions from these laws may also provide better protection of donors' confidential information.

Independent institutions are generally not covered by the open meeting and open records laws. For these institutions, however, there may be some benefit in having their endowment assets contained as a separate entity, particularly if there are concerns about the survival of the institution.

In establishing affiliated foundation agreements, it is important to define the particular relationship between the foundation and the institution, establish clearly the service and benefits that each entity will receive, and implement any other controls that the institution deems necessary to protect itself and its fund raising efforts.

When auditing the institution's affiliated foundations, the key questions to ask are :

- ◆ What is the reason for the establishment of the foundation?
- ◆ Is the appropriate legal structure used?
- ◆ Is there a service agreement between the foundation and the institution?

- ◆ Does the service agreement contain the appropriate provisions for responsibility and indemnification?
- ◆ Does the institution have the right to abolish the entity or to control its governing board if such action is needed?

IX. Record Retention

The institution should develop policies regarding retention of gift and alumni records, and donor files.

A gift to an institution is considered income and must be treated as a tax record. Records of current cash gifts should be retained at least 4 years from the time they are given but do not need to be retained more than 7 years. Records of non-cash gifts, such as real property or stock, should be retained during the time the institution has possession of the gift plus at least 4 years after possession is relinquished. If the value of a non-cash gift exceeds \$500, the donor must complete Form 8283, which is attached to the donor's federal income tax return. Form 8283 must contain a description of the property, the institution's acknowledgment of receipt, and for certain property, a qualified appraiser's valuation of the gift.

In some cases, the Internal Revenue Service requires that the institution retain certain gift records for a period of years. In its annual Form 990 return, an institution must report all gifts and must identify the names and addresses of all substantial contributors. An institution's Form 990 return must be made available to the public during regular business hours for 3 years after the return is filed.

Most contributors appreciate having their gifts acknowledged in some manner. If a donor requests anonymity, this request should be honored as much as possible.

Since there are no legal requirements for alumni record collection and retention, record retention decisions should be

based on institutional needs. However, alumni publications have been identified as one of the documents subject to Internal Revenue Service inspection during an audit. Therefore, if these publications are kept, they should be retained for 3 years from the date the institution's tax return was filed if published for that year, or 4 years from the date of the publication. Current information is usually kept during the lifetime of the former student, with records purged upon the former student's death.

Alumni information may be used to plan class reunions, solicit charitable gifts, and solicit job leads for current graduates. Alumni records provide the information that is available in alumni newsletters and directories, and news of a particularly notable former student may enhance an institution's recruiting efforts.

In auditing an institution's record retention policies, the key questions to ask are :

- ◆ What is the institution's retention policy on alumni records?
- ◆ How long does the institution retain gift records and data for the Internal Revenue Service?
- ◆ What is the institution's policy on storage of records?
- ◆ Has the institution developed a policy on access to alumni records by alumni and does that policy require consent?
- ◆ What is the institution's policy on access to donor records?
- ◆ What is the institution's policy on reviewing files to remove sensitive donor research data?

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