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LEGAL ASPECTS OF CHANGING UNIVERSITY INVESTMENT STRATEGIES

GEORGE C. CHRISTIE†

Until the early 1970s most private colleges and universities followed conservative investment strategies. To better finance the expanding scope of higher education, many private colleges and universities then began to move increasingly toward common stock. The total return on common stock in the seventies, however, proved insufficient to meet increasing budgetary requirements. In 1978, Duke University, following the lead of other private institutions, further diversified its portfolio by investing \$2.16 million of unrestricted endowment funds in unimproved real property. In an analysis applicable to many private colleges and universities across the nation Professor Christie assesses the legality of this strategy under North Carolina law. Professor Christie then offers general guidelines for trustees of private colleges and universities seeking to embark on more aggressive investment strategies.

Traditionally, private colleges and universities have followed a very conservative investment posture. At the same time, with the expansion in the scope of higher education since the end of the Second World War, the income from the endowments of these institutions has generally declined as a percentage of the total income available to support these expanded activities.¹ The result has been an expanding and uneasy dependence on potentially fickle sources, such as federal funds and annual giving campaigns, to supplement increasingly frequent tuition hikes. The only way out of this vicious cycle, which has left private institutions of higher learning increasingly subject to changes in the giving patterns of outside sources, is for these institutions to expand substantially the size of their endowment funds *and* to increase the yield from their present endowments. To implement the first branch of this strategy, virtually all major private colleges and universities have undertaken, with varying degrees of success, intensive efforts to in-

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1. See THE TWENTIETH CENTURY FUND TASK FORCE ON COLLEGE AND UNIVERSITY ENDOWMENT POLICY, FUNDS FOR THE FUTURE 26-27 (1975).

crease their endowments. This Article is concerned with some of the legal aspects of the second branch of the strategy, the effort to increase the rate of return from existing endowments.

I. BACKGROUND

In the late 1960s, the endowment funds of most private colleges and universities continued to follow a conservative investment strategy.² The rapid increase in stock prices during the decade of the sixties, however, and the marked success of some famous institutions such as Harvard, which had early on made substantial investments in common stock, led many private colleges and universities to reexamine their traditional investment policies. A stumbling block to dramatic change in investment policy was that a major shift towards common stock would lead to a diminution in current income because the dividend rate on common stocks has, in recent times, usually been less than the rates of return available on fixed-income securities, and this was certainly the case in the late 1960s.³ Therefore, insofar as university endowment funds had been donated under the condition that only the "income" from these funds could be expended for current operations, a significant further shift of investment policy toward common stock would place intolerable strains on the budgets of the many private colleges and universities already experiencing grave difficulties in balancing their operating budgets. In order to permit private colleges and universities to change the focus of their investment policies to feature investment in common stocks more prominently, it was urged that private colleges and universities move to a total return method of accounting for their endowment funds.⁴ Under this concept, "income" from en-

2. "Traditionally, college endowments have been managed by trustees who have been content to produce a modest but safe annual income through investment in fixed-yield securities." FORD FOUNDATION, *PAYING FOR SCHOOLS AND COLLEGES* 22 (1976). The actual record is of course more complex. Until the 1830s, college endowment funds were invested in notes, mortgages, advances, and real estate. Investments in common stock then started to be made. Following the Civil War, however, investment in common stock declined and substantial investments were made in government and railroad bonds. In the 1920s, there was some movement again into common stocks and a decline in investments in real estate and mortgages. During World War II, there was an increase in investment in stocks and investments in real estate continued to decline. The movement into common stock continued in the 1950s and, of course, accelerated in the 1960s. See THE TWENTIETH CENTURY FUND TASK FORCE ON COLLEGE AND UNIVERSITY ENDOWMENT POLICY, *FUNDS FOR THE FUTURE* 97-98 (1975).

3. In 1970, the Ford Foundation reported "[t]oday prime bonds yield more than twice as much as most common stocks, and some of the best equities provide little or no dividend yield at all." FORD FOUNDATION, *MANAGING EDUCATIONAL ENDOWMENTS* 17 (1969).

4. The Ford Foundation was prominent in urging this change in investment and accounting policy. See W. CARY & C. BRIGHT, *THE LAW AND THE LORE OF ENDOWMENT FUNDS* (Report to

dowment funds invested in common stock would include not only the dividends paid on the shares held by the fund but also some portion of the expected capital gains.⁵

Private college and university endowment funds fall into two broad categories. In the first category are funds given to those institutions unconditionally. These funds can be used for current operations or for capital projects but, in the 1960s, were in fact added to endowment. In one of the major legal analyses of the investment policies of private colleges and universities undertaken through the sponsorship of the Ford Foundation in the late 1960s, it was concluded that, with regard to the portion of an endowment that consisted of these unrestricted funds, private colleges and universities could decide to move to total return accounting principles with little legal risk.⁶ And, in point of fact, many major private colleges and universities did make this move. Typically, total return accounting was implemented by treating these unrestricted funds as a "quasi-endowment" that was subject to different investment strategies and accounting principles than what might be called "regular" endowment funds.⁷

The legal situation was more difficult with regard to the other major category of endowment funds, the category that I have called "regular" endowment. "Regular" endowment funds are given to a private college or university under instruments specifying that the income from

the Ford Foundation 1969); W. CARY & C. BRIGHT, *THE DEVELOPING LAW OF ENDOWMENT FUNDS: "THE LAW AND THE LORE" REVISITED* (Report to the Ford Foundation 1974). The Foundation itself adopted the total return method of accounting in June 1971. FORD FOUNDATION, *ANNUAL REPORT* OCTOBER 1, 1970 TO SEPTEMBER 30, 1971, at 92 (1971).

5. For example, suppose that the endowment fund of X University received 1,000 shares of ABC Corporation with a market price of \$50 per share. Further suppose that the endowment trustees decide because of a restriction in the gift instrument or for other policy reasons, that only the "income" from the stock will be expended each year. Assume that the stock pays a \$2 per share annual dividend and that one year after X University's receipt of the shares, the stock had a market price of \$54 per share. If "income" is defined in the traditional way, X University will have \$2000 available for expenditure—the \$2 dividend times 1,000 shares. If, however, the total return method of accounting is adopted, "income" will include some price appreciation in addition to dividends actually paid. Thus, X University, under the total return method, would have as much as \$6,000 of current income from this investment—the \$2 dividend plus the \$ price appreciation times 1,000 shares. Typically, however, in order to allow for inflation and other contingencies, only some portion of the capital appreciation would be allocated to income.

6. W. CARY & C. BRIGHT, *THE LAW AND THE LORE OF ENDOWMENT FUNDS* 10-11, 50-51 (Report to the Ford Foundation 1969). The study emphasized that, even with regard to funds which in some ways required "that principal is to be kept intact or that only income is to be spent," *id.* at 11, it was not at all clear that total return accounting was illegal. *Id.* at 32-33. The report recommended procedures, including suits for declaratory judgments and the passage of legislation, to clarify the situation and establish the legality of the proposed change in private college and university endowment investment policies. *Id.* at 47-52.

7. See, e.g., DUKE UNIVERSITY 1978 FINANCIAL REPORT 22.

the funds should be used either for specific purposes or for the general purpose of supporting the operations of the donee. To provide for more flexible investment of these funds, the Uniform Management of Institutional Funds Act was promulgated by the Commissioners on Uniform State Laws in 1972.⁸ As of January 1, 1979, the Act had been adopted by twenty-five states and the District of Columbia.⁹ Under section two of the Act, "[t]he governing board [of an institution] may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent"¹⁰ The Act has not been adopted in North Carolina, although, as we shall soon see, the special statutory scheme governing the endowment funds of the University of North Carolina does contain authority to adopt a similar total return method of accounting for endowment fund income.¹¹

8. The Commissioners' Prefatory Note specifically notes that the first Cary and Bright study, *supra* note 4, was a principal impetus for the drafting of the Act. 7A UNIFORM LAWS ANNOT. 405-07.

9. CAL. CIV. CODE §§ 2290.1-.12 (West Cum. Supp. 1979); COLO. REV. STAT. §§ 15-1-1101 to -1109 (1973); CONN. GEN. STAT. §§ 45-100h to -100p (West Cum. Supp. 1979); DEL. CODE ANN. tit. 12, §§ 4701 to 4708 (Cum. Supp. 1978); D.C. CODE ANN. §§ 32-1201 to -1209 (Supp. V 1978); ILL. ANN. STAT. ch. 32, §§ 1101 to 1110 (West Cum. Supp. 1979); KAN. STAT. §§ 58-3601 to -3610 (1976); KY. REV. STAT. §§ 273.510 to .590 (Cum. Supp. 1978); LA. REV. STAT. ANN. §§ 9:2337.4 to .8 (West Cum. Supp. 1979); MD. EST. & TRUSTS CODE ANN. 15-401 to -409 (1974); MASS. ANN. LAWS ch. 180A, §§ 1 to 11 (Law. Co-op 1976 & Cum. Supp. 1978); MICH. COMP. LAWS §§ 451.1201 to .1210 (MICH. STAT. ANN. §§ 26.1199(1) to (10) (Callaghan Cum. Supp. 1979)); MINN. STAT. ANN. §§ 309.62 to .71 (West Cum. Supp. 1979); MONT. REV. CODES ANN. §§ 86-801 to -809 (Cum. Supp. 1977); N.H. REV. STAT. ANN. §§ 292-B:1 to :9 (1955 & Cum. Supp. 1977); N.J. STAT. ANN. §§ 15:18-15 to -24 (West Cum. Supp. 1979); N.Y. NOT-FOR-PROFIT CORP. LAW §§ 102.512, .514, .522 (McKinney 1970 & Cum. Supp. 1978); N.D. CENT. CODE 15-67-01 to -09 (Cum. Supp. 1977); OHIO REV. CODE ANN. 1715.51 to .59 (Page 1978); OR. REV. STAT. 128.310 to .355 (1977); R.I. GEN. LAWS 18-12-1 to -9 (Cum. Supp. 1978); TENN. CODE ANN. §§ 35-1101 to -1109 (1977); VT. STAT. ANN. tit. 14, §§ 3401 to 3407 (1974); VA. CODE 55-268.1 to .10 (1974); WASH. REV. CODE ANN. §§ 24.44.010 to .900 (Cum. Supp. 1978); WIS. STAT. ANN. § 112.10 (West Cum. Supp. 1979).

10. UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT § 2. The Act goes on to establish the following rule of construction:

Section 2 does not apply if the applicable gift instrument indicates the donor's intention that net appreciation shall not be expended. A restriction upon the expenditure of net appreciation may not be implied from a designation of a gift as an endowment, or from a direction or authorization in the applicable gift instrument to use only "income," "interest," "dividends," or "rents, issues or profits," or "to preserve the principal intact," or a direction which contains other words of similar import. This rule of construction applies to gift instruments executed or in effect before or after the effective date of this Act.

Id. § 3. New York, Massachusetts and California are among the states that have adopted the Act. See CAL. CIV. CODE §§ 2290.1 to .12 (West Cum. Supp. 1978); MASS. ANN. LAWS ch. 180A, §§ 1 to 11 (Law. Co-op 1977); N.Y. NOT-FOR-PROFIT CORP. LAW §§ 102, 512, 514, 522 (McKinney Cum. Supp. 1978).

11. See text accompanying note 64 *infra*.

Thus, in the early 1970s, many private colleges and universities responded to the perceived need to move from a fixed-income investment strategy to a strategy placing greater emphasis on common stocks. To avoid the budgetary strain caused by the lower dividend yield of common stocks, they utilized both the device of segregating unrestricted funds as quasi-endowments and/or, where possible, the broad authority granted by the Uniform Management of Institutional Funds Act¹² to treat a portion of the expected capital gains of endowment funds as current income.

Unfortunately, by the time many private colleges and universities had discovered the attraction of total return accounting and entered the stock market on a larger scale, the long bull-market of the 1960s had come to an end. In 1973, the compound annual return, including dividend and interest income, of the University of Rochester's endowment was minus 21.7 percent.¹³ Between June of 1973 and October of 1974, Dartmouth College's endowment had shrunk from \$170.3 million to somewhere between \$130 and \$135 million.¹⁴ Harvard lost roughly \$300 million in the same period, although on a percentage basis its losses were considerably less.¹⁵ Perhaps the most dramatic losses were suffered by the Ford Foundation itself. On October 15, 1974, *The New York Times* reported that the endowment of the Ford Foundation had shrunk from \$3 billion to \$2 billion.¹⁶ As a result, the Foundation had to cut back considerably on its annual grants.¹⁷ Looking at a longer time frame, it was reported that in the period between 1967 and 1978, a period during which the consumer price index doubled, the total endowment of Yale University remained the same, despite the receipt of more than \$100 million in capital gifts.¹⁸

Faced with these completely unsatisfactory results, private colleges and universities recognized that something had to be done to improve their returns on investments. With the high interest rates currently available, a prudent investment policy for private colleges and universities during the present period would obviously include some invest-

12. UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT § 2.

13. N.Y. Times, Apr. 11, 1974, at 50, col. 2.

14. *Id.* Jan. 15, 1975, at 86, col. 3.

15. *Id.* at col. 2.

16. *Id.* Oct. 15, 1974, at 39, col. 2.

17. See FORBES, November 1, 1977, at 105. This article describes the Foundation's unhappy experience with its investment in a Houston land development company.

18. N.Y. Times, Dec. 10, 1978, at 69, col. 1. The article notes that until recently Yale had 60% of its funds invested in common stock.

ment in fixed-income securities, which are also usually safer than many other types of investment. But such a policy will at best merely enable these institutions to keep pace with inflation. Indeed the returns on high-grade, long-term investments are below the current rate of inflation. To keep up with or beat inflation, a different investment policy is necessary. Small wonder, then, that in the past few years many private colleges and universities have started putting money in a wide variety of investment situations. These institutions have started to invest increasingly in shopping centers, office buildings, unimproved land, and venture capital situations, and have even made some investment in commodities.¹⁹ Indeed, during the stagnant, and sometimes even declining, stock market of recent years, many private colleges and universities have regularly sold covered options.²⁰ In September 1978, Duke University announced that it had joined this trend by investing some \$2.16 million of unrestricted or quasi-endowment funds in 1,222 acres of unimproved land located north of Raleigh.²¹

The purpose of the present Article is not to assess the wisdom of any such change in investment policy, although given the current economic situation some change in investment strategy seems necessary even in the face of some risk. Rather, this article has two purposes: first, to assess the legality of such an investment policy under North Carolina law; and second, to suggest some guidelines to help the trustees of private colleges and universities to insulate themselves from legal attack should they decide to embark on this more aggressive investment strategy.

19. See FORTUNE, December 18, 1978, at 70.

20. To sell or "write" an option means that an investor sells his promise to buy a certain stock at a specific price, often called the striking price, on or before a predetermined date in the future (put option) or sells his promise to sell a certain stock for a specific price on or before a predetermined date in the future (call option). To be "covered" means that the writer of a call option actually has the stock to sell if the option is exercised by the purchaser. The purchaser will exercise the call option if the market price of the stock exceeds the call price. Thus, the writer is betting that the market price will be below the call price. If this is not the case, and the option is exercised, the covered option writer must sell the stock he has at the call price. The risk to the writer is that there will be a net loss on the transaction equal to the appreciation of the stock over the call price minus the amount received when the option was written. The potential gain, of course, is that the market price will not go above the call price so the option will expire and the writer will be left with what was received for writing it. By writing covered call options, colleges and universities can receive "income" in addition to dividends on their stock holdings that are not appreciating in price. See generally T. JOHNSON, INVESTMENT PRINCIPLES 351-61 (1978); R. STEVENSON & E. JENNINGS, FUNDAMENTALS OF INVESTMENTS 497-502 (1976). For further discussion see note 122 and accompanying text *infra*.

21. Durham Morning Herald, Sept. 7, 1978, § C, at 1, col. 3.

II. THE LAW OF NORTH CAROLINA AS IT AFFECTS THE INVESTMENT POLICIES OF PRIVATE NORTH CAROLINA COLLEGES AND UNIVERSITIES

A. *The Legal Status of North Carolina Colleges and Universities*

The typical North Carolina private college or university is a charitable corporation and, more likely than not, subject to the provisions of the Nonprofit Corporation Act of North Carolina.²² The North Carolina Act is based upon the Model Nonprofit Corporation Act developed by the American Bar Association's Committee on Corporate Laws in 1952.²³ Most North Carolina colleges and universities were established as corporate entities long before the Model Act was drafted and subsequently adopted by the North Carolina General Assembly in 1955.²⁴ Nevertheless, those organized before passage of the Act *without* capital stock are covered by the Act.²⁵ On the other hand, those colleges and universities organized as charitable corporations prior to the Act *with* capital stock are not covered by the Act.²⁶ Some of these institutions, however, have availed themselves of the power granted by the Act to amend and restate their charter, file it with the Secretary of State and thus become covered.²⁷

The general powers granted to corporations governed by the Act and the powers granted for carrying out the purposes stated in the corporation's charter, particularly the powers to hold and dispose of property, are as full and wide-ranging as one could hope.²⁸ The only

22. N.C. GEN. STAT. ch. 55A (1975 & Cum. Supp. 1977).

23. ABA MODEL NONPROFIT CORP. ACT (1952 version).

24. Non-Profit Corporation Act, ch. 1230, 1955 N.C. Sess. Laws 1239 (codified at N.C. GEN. STAT. §§ 55A-1 to -89.1 (1975 & Cum. Supp. 1977)).

25. N.C. GEN. STAT. § 55A-3(a)(2) (1975).

26. *Id.* See also R. ROBINSON, NORTH CAROLINA CORPORATION LAW AND PRACTICE 1-3 (2d ed. 1974).

27. N.C. GEN. STAT. § 55A-37.1 (1975). The only North Carolina charitable corporations not covered by the Act are nonprofit corporations having capital stock that have not restated their charter and those nonprofit corporations organized under specific statutory provisions, such as hospitals and medical service corporations incorporated prior to July 1, 1957. See *id.* § 55A-3(a).

28. *Id.* § 55A-5 provides that North Carolina nonprofit corporations may be organized for "any lawful purposes." Section 55A-15(a) enumerates nine specific corporate powers that may be exercised by North Carolina nonprofit corporations without regard to the purposes for which the corporation was created. *Id.* § 55A-15(a). Section 55A-15(b) enumerates eight powers that may be exercised in connection with the purposes stated in the charter, among which are the powers

[t]o acquire, by purchase, subscription, gift, will or otherwise, and to own, hold, vote, use, employ, sell, mortgage, lend, pledge, or otherwise dispose of, and otherwise use and deal in and with, shares or other interests in, or obligations of, domestic or foreign business corporations, associations, partnerships or individuals, or direct or indirect obligations of the United States or of any government, state, territory, governmental district or municipality or of any instrumentality thereof; [and] [t]o make contracts and incur liabilities,

restrictions on these powers are those limitations imposed by the Act,²⁹ those imposed by a corporation's own charter,³⁰ and, for those non-profit corporations classified as "private foundations" under section 509 of the Internal Revenue Code,³¹ the limitations imposed by federal revenue laws as the price for favorable tax treatment.³² The typical private college or university is, of course, not a "private foundation" under section 509.³³ To use Duke University as an example, section two of its restated charter states that the University shall have "all powers granted to non-profit corporations under the law of the State of North Carolina for any lawful education, charitable, scientific, literary or public service purposes."³⁴ The only limitations imposed by the University's restated charter are on activities that are forbidden under federal tax law to corporations that seek either to be themselves exempt from federal income tax or to obtain tax deductible status for contributions made to them. Thus, a North Carolina private college or university, as a nonprofit corporation, has a great deal of freedom in acquiring, holding and disposing of assets.

Private colleges and universities, however, are more than nonprofit corporations: they are nonprofit corporations organized for educational and charitable purposes. They are, in short, what at common law would be called charitable corporations.³⁵ In the management of their affairs, they typically operate as corporations. The boards of trustees of such institutions, for example, typically delegate decision-making, particularly on the management and investment of their institutions' assets, to an extent that would be improper for trustees of

borrow money, issue its notes, bonds, and other obligations, and secure any of its obligations by mortgage or pledge of all or any of its property, franchises and income.

Id. § 55A-15(b)(3), (4).

29. *Id.* § 55A-15(b). For example, the Act prohibits loans to directors or officers. *Id.* § 55A-18.

30. *Id.* § 55A-15(b).

31. I.R.C. § 509.

32. N.C. GEN. STAT. § 55A-15(c) (1975). A foundation may, however, avoid these restrictions under state law by stating in its charter its intention not to be limited by the federal tax provisions. *Id.*

33. I.R.C. § 509. Although a foundation organized for educational purposes may be considered a private foundation, § 509 exempts organizations described in *id.* § 170(b)(1)(a), one of which is an "educational organization which normally maintains a regular faculty and curriculum." *Id.*

34. See BULLETIN OF DUKE UNIVERSITY, DIRECTORY OF OFFICERS, FACULTY, AND STAFF 1977-78, app. at 77.

35. See, e.g., *Scholarship Endowment Foundation v. Nicholas*, 25 F. Supp. 511, 513 (D. Colo. 1938); *Trustees of Iona College v. Baille*, 236 Iowa 235, 241, 17 N.W.2d 143, 147 (1945); *Farm & Home Savings & Loan Ass'n v. Armstrong*, 337 Mo. 349, 359-60, 85 S.W.2d 461, 467 (1935).

trusts.³⁶ The question thus is not, "Are private colleges and universities charitable trusts rather than charitable corporations,"—in the typical case they are clearly not—but rather, "Are there any circumstances in which the trustees of a private college or university would be required to comply with restrictions imposed upon the trustees of charitable trusts?" If so, what are these restrictions and how would they operate to confine the investment discretion of the trustees of private colleges and universities?

B. Are the Trustees of Private Colleges and Universities Subject to Some of the Restrictions on Investments Applicable to Charitable Trusts?

The way in which the problem arises can be concisely stated by tracking the *Restatement (Second) of Trusts*. Section 379 of the *Restatement (Second)* states categorically that the duties of the trustee of a charitable trust are similar to the duties of the trustee of a private trust.³⁷ The only differences recognized in the comment to section 379 between private and charitable trusts are that, in the case of charitable trusts, the duties of the trustees are ordinarily not enforceable other than by the suit of the attorney general and that, in the case of a charitable trust, a majority is controlling whereas, in the case of private trusts, there is a rule of unanimity among the trustees unless the trust instrument provides otherwise.³⁸ The comment to section 379 then goes on to state:

b. Charitable corporations. In the case of a charitable corporation duties of a somewhat similar character rest upon the members of the controlling board, whether they are called directors or trustees. The extent of the duties is not always the same as the extent of the duties of individual trustees holding property for charitable purposes. It may be proper, for example, for the board to appoint a committee of its members to deal with the investment of the funds of the corporation, the board merely exercising a general supervision over the actions of the committee.³⁹

The *Restatement (Second) of Trusts* was published in 1959. The sug-

36. See *Mass. Charitable Mechanic Ass'n v. Breede*, 320 Mass. 601, 70 N.E.2d 825 (1947). See generally Committee on Charitable Trusts and Foundations, *Delegation of Investment Responsibility by Trustees of Charitable Trusts and Corporations*, 9 REAL PROP. PROB. & TR. J. 583 (1974).

37. RESTATEMENT (SECOND) OF TRUSTS § 379 (1959).

38. *Id.*, Comment a, b. Under North Carolina law, a majority of the trustees can exercise most of the powers of administration unless the trust instrument provides otherwise. N.C. GEN. STAT. § 36A-74 (Cum. Supp. 1977).

39. RESTATEMENT (SECOND) OF TRUSTS § 379, Comment b (1959).

gestion that for some purposes duties similar to those of trustees of charitable trusts devolve upon trustees or directors of charitable corporations is repeated by Austin Wakefield Scott, the Reporter for the *Restatement (Second) of Trusts*, in the last major revision (1967) of his standard treatise on the law of trusts.⁴⁰ The questions before us then become: first, when might a court accept that, for certain investment purposes and decisions, the duties of the trustees of a charitable corporation are "of a somewhat similar character" to those resting upon trustees of trusts; and, second, what restrictions would that characterization place upon the investment decisions of the trustees of a charitable corporation? There is also a related question whether, *if* a mistake in judgment is made, a different standard of care is imposed upon the trustees of a charitable trust than upon the trustees of a charitable corporation. This latter point will be examined below in connection with a discussion of the liability of trustees of charitable corporations.

It will come as no surprise that North Carolina case law provides no help in deciding when the duties of the trustees of charitable corporations are similar to those of the trustees of trusts or in ascertaining what consequences, if any, such a characterization would entail. Moreover, the North Carolina Supreme Court has, on a number of occasions, even drawn an analogy between the directors of business corporations and trustees as the fiduciaries of a trust on the basis of the so-called trust fund theory. Typical of such judicial declarations is Judge Brogden's statement that "[d]irectors and managing officers of a corporation are deemed by the law to be trustees, or *quasi* trustees, in respect to the performance of their official duties incident to corporate management and are therefore liable for either wilful or negligent failure to perform their official duties."⁴¹

For enlightenment on this subject, it is therefore necessary to turn again to general authorities such as the *Restatement (Second) of Trusts*. In section 389, the *Restatement (Second)* declares that "[i]n making investments . . . the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust."⁴² In the comment following this section, however, the statement is made that even in states in which

40. 4 A. SCOTT, THE LAW OF TRUSTS § 389 (3d ed. 1967).

41. *State v. Harnett County Trust Co.*, 192 N.C. 246, 248, 134 S.E. 656, 657 (1926), *quoted in* *Roscow v. Bizzell*, 199 N.C. 656, 657, 155 S.E. 558, 559 (1930). For an earlier expression of a similar idea, see *Besseliew v. Brown*, 177 N.C. 65, 67, 97 S.E. 743, 744 (1919). For a recent reiteration of the same point, see *Underwood v. Stafford*, 270 N.C. 700, 702-04, 155 S.E.2d 211, 212-13 (1967).

42. RESTATEMENT (SECOND) OF TRUSTS § 389 (1959).

there are restrictions, either by statute or otherwise, as to the *kinds* of investments trustees can make, such restrictions are not applicable to charitable corporations.⁴³ Charitable corporations may, rather, invest as would a prudent man.⁴⁴ While the *Restatement (Second)* provides no more guidance on this matter, Professor Scott makes it clear in his treatise that the investment freedom possessed by the trustees of charitable corporations is the freedom possessed by private trustees in a state such as Massachusetts, in which there are no statutory restrictions on the kinds of investments such a trustee can make. It is not an unlimited freedom but merely the freedom to make "such investments as a prudent man would make of his own property with a view to the preservation of the property and the amount and regularity of the income to be derived."⁴⁵ The cases cited by Scott, however, provide no further guidance.

Leaving the question of the investment freedom of charitable corporations, for the moment, what are the restrictions on the investment freedom of private trustees in North Carolina? For a number of years North Carolina had a rather narrow statutory list of approved investments that might be made by trustees of trusts and other fiduciaries.⁴⁶ Whether this scheme actually limited the investments of trustees to the statutory list or merely indicated what investments were *prima facie* permissible was apparently never definitively determined.⁴⁷ Nevertheless, as a practical matter, a cautious trustee would invest in other categories of investments only if he were granted specific authority in the trust instrument. Effective January 1, 1978, these putative restrictions were repealed.⁴⁸ They were replaced by a provision that

[Subject to the prudent man rule] . . . a fiduciary is authorized to acquire and retain every kind of property and every kind of investment, including specifically, but without in any way limiting the gen-

43. *Id.*, Comment b, reads as follows:

Charitable corporations: Where money is given to a charitable corporation for its general purposes, it may make such investments as a prudent man would make. Even in a State in which trustees are restricted, by statute or otherwise, to certain kinds of investments, the restriction is not applicable. Even though the corporation is directed to invest the funds and use only the income, either for any of its purposes or for a particular one of its purposes, the restriction applicable to trustees is not applicable to it, unless it is otherwise provided by the terms of the gift.

44. *Id.*

45. 4 A. SCOTT, *supra* note 40, at 2998-99.

46. Law of Apr. 3, 1871, ch. 197, 1870 N.C. Pub. Laws 315 (current version at N.C. GEN. STAT. §§ 36-1 to -5.2 (1976)).

47. The preferred view has been that the statutory list is permissive, not restrictive. See R. LEE, NORTH CAROLINA LAW OF TRUSTS 90 (6th ed. 1977).

48. Law of June 8, 1977, ch. 502, § 1, 1977 N.C. Sess. Laws 583.

erality of the foregoing, bonds, debentures, and other corporate or governmental obligations; stocks, preferred or common; real estate mortgages; shares in building and loan associations or savings and loan associations; annual premium or single premium life, endowment, or annuity contracts; and securities of any management type investment company or investment trust registered under the Federal Investment Company Act of 1940, as from time to time amended.⁴⁹

Since January 1, 1978, there have thus been no specific restrictions upon the type of investments that can be made by a fiduciary in North Carolina. Whether specific investments that might be made by a fiduciary are prudent is another question, however. Most of the property held by private colleges and universities is, of course, not held by them as fiduciaries.⁵⁰ That is why there has been no attempt to apply the restrictions on the transference of assets out of North Carolina by fiduciaries to private colleges and universities.⁵¹ Nevertheless, it is obviously helpful for our purposes that even fiduciaries in North Carolina have broad investment freedom.

Professor Scott asserts that under the prudent investor rule now applicable to fiduciaries in North Carolina and most other states⁵² trustees are not permitted to purchase securities for speculation although he admits that the line between speculation and investment is often hard to draw.⁵³ Thus, Scott declares that a trustee cannot purchase securities in new and untried enterprises⁵⁴ or use trust property in carrying on a trade or business, even though it is not an untried enterprise.⁵⁵ Moreover, Scott maintains that a trustee cannot properly use funds "in the purchase of land or *other things* for the purpose of resale."⁵⁶ The fundamental premise for Scott's conclusions is that a trustee is not allowed to take risks that even a prudent businessman

49. Law of June 8, 1977, ch. 502, § 2, 1977 N.C. Sess. Laws 583 (codified at N.C. GEN. STAT. § 36A-2(b) (1977)). The national trend has been to abolish the inflexibility of statutory or "legal" lists, which now exist in only a few states. See Note, *Prudence in Trust Investment*, 8 U. MICH. J. L. REF. 491, 491-92 (1975); cf. Note, *The Regulation of Risky Investments*, 83 HARV. L. REV. 603, 613-14 (1970).

50. See *Y.W.C.A. v. Morgan*, 281 N.C. 485, 494, 189 S.E.2d 169, 175 (1972) ("Where property is given to a corporation for such uses as are within the scope of its corporate powers, the conveyance does not create a trust." (quoting *Sands v. Church of Ascension*, 181 Md. 536, 541, 30 A.2d 771, 774 (1943))).

51. The current provision regarding removal of fiduciary funds from North Carolina is at N.C. GEN. STAT. § 36A-13 (1977).

52. See note 49 *supra*.

53. 3 A. SCOTT, *supra* note 40, at 1816.

54. *Id.*

55. *Id.* at 1816-17.

56. *Id.* at 1817 (emphasis added).

would be prepared to take.⁵⁷ This is because “[t]he primary purpose of a trustee should be to preserve the trust estate, while receiving a reasonable amount of income, rather than to take risks for the purpose of increasing the principal or income. In other words, a trustee must be not merely careful and skillful but also cautious.”⁵⁸

But many private colleges and universities are presently considering what they may do with unrestricted funds—funds the principal and interest of which they may spend as they please to further the lawful purposes of their institutions. They are not confronted with the problem of reconciling the interests of beneficiaries for life with those of the remaindermen as is the trustee of a private trust. Scott’s conclusions, which are premised upon an assumption that preservation of principal is a paramount consideration, would thus not seem to be applicable, at least to unrestricted funds of private colleges and universities. As will be discussed in more detail below, many major private universities have participated in venture capital investments, that is, investments in untried enterprises.⁵⁹ Furthermore, many such institutions have bought unimproved land, and such investments could sometimes be construed as a “purchase of land . . . for the purpose of resale.”⁶⁰ At least, therefore, with regard to unrestricted funds, the only possible conclusion is that Scott’s strictures are by their very terms not applicable⁶¹ and that major private colleges and universities have actually treated those strictures as inapplicable.⁶²

57. *Id.* at 1811.

58. *Id.*

59. See text accompanying notes 116-121 *infra*.

60. 3 A. SCOTT, *supra* note 40, at 1817.

61. This conclusion can be easily reconciled within the analytical framework of the *Restatement (Second) of Trusts* discussed earlier. The *Restatement (Second)* indicates that the duties of trustees of charitable corporations are “somewhat similar” to the duties of trustees of charitable trusts although they are “not always the same,” and the duties of trustees of charitable trusts are, in turn, “similar” to the duties of trustees of private trusts. To avoid having the prohibition of speculative, business-risk investment apply to the trustees of charitable corporations, it would be necessary to find that their duties in this area differ from those of trustees of charitable trusts or, alternatively, that the duties of trustees of charitable trusts differ from those of trustees of private trusts. For our purposes it is irrelevant where this distinction is drawn; the *Restatement (Second)* by describing the duties of these various trustees as only “similar” or “somewhat similar” offers an opportunity to make the distinction at either level. Perhaps the more appropriate argument is that the duties with respect to speculative, business-risk investment applicable to trustees of charitable corporations differ from those applicable to trustees of charitable trusts. It is here that the *Restatement (Second)* hedges not only by finding the duties only “somewhat similar” but also by specifically recognizing a distinction with respect to the investment function. See text accompanying notes 37-39 *supra*.

62. In 1951, the Attorney General of New York issued an opinion that the “powers of trustees of an educational, religious or charitable corporation in respect to the administration and investment of the corporation’s funds are fundamentally no different than that of a director of a

Although the trustees of charitable corporations should not be prohibited from using unrestricted funds for speculative, business-risk investments, whether any particular investment by a private college or university will be considered prudent is another question. The resolution of that question, however, will depend upon the rational basis for the investment and not upon such *a priori* considerations as how the investment might be characterized.

When the question is whether the trustees of a particular charitable corporation have behaved prudently, the practice of trustees of other charitable corporations will be of crucial relevance. Thus, a brief review of the investment practices of major private colleges and universities will be set forth at the close of part III of this Article prior to an attempt in part IV to propose guidelines that should be followed should a private college or university decide to broaden the range of investments that it is prepared to make out of its unrestricted funds. In the remainder of this portion of the Article, however, I shall first discuss the assistance, if any, that may be derived from the law governing the University of North Carolina endowment funds and then examine the actual standard by which the liability of the trustees of private colleges and universities will be determined if any investments authorized by them prove to be unsuccessful.

C. *The Legal Regime Governing the University of North Carolina Endowment Funds*

Any study of the strictures imposed by North Carolina law upon the investment policies of private colleges and universities must consider the analogies provided by the statutory framework governing the University of North Carolina Endowment Funds. The principal provisions of this statutory framework are contained in section 116-36 of the General Statutes of North Carolina.⁶³ As originally enacted in 1971,

business corporation," and this position was eventually confirmed by statute. Wheeler, *Fiduciary Responsibilities of Trustees in Relation to the Financing of Private Institutions of Higher Education*, 2 J.C. & U.L. 210-13, 212 n.8 (1975) (citing 1951 Op. Att'y Gen. 159). See N.Y. NOT-FOR-PROFIT CORP. LAW § 513(b) (McKinney Cum. Supp. 1978). For criticism of Scott's views, even as applied to trusts, see Fleming, *Prudent Investments: The Varying Standards of Prudence*, 12 REAL PROP. PROB. & T.J. 243 (1977); Comment, *Investment and Management of Trust Funds in an Inflationary Economy*, 126 U. PA. L. REV. 1171 (1978). The trust notion, espoused by Scott, 3 A. SCOTT, *supra* note 40, at 1809, that each investment must be judged separately and losses on one investment cannot be offset by gains on others, is criticized as irrational in Note, *The Regulation of Risky Investments*, 83 HARV. L. REV. 603, 616-25 (1970). See also Comment, *supra*, at 1190-91. The anti-netting rule, as applied to trusts, was reaffirmed in *In re Bank of New York* (Spitzer), 35 N.Y.2d 512, 323 N.E.2d 700, 364 N.Y.S.2d 164 (1974).

63. N.C. GEN. STAT. § 116-36 (1978).

the most important of these provisions with respect to the regulation of endowment investments were subsections (e) and (f), which provided:

(e) The trustees of the endowment fund shall be responsible for the prudent investment of the fund, in the exercise of their sound discretion, without regard to any statute or rule of law relating to the investment of funds by fiduciaries.

(f) The principal of said endowment fund shall be kept intact and only the income therefrom may be expended. The trustees of the endowment fund shall determine what is income and what is principal.⁶⁴

Private colleges and universities had been particularly interested in subsection (f), which appeared to allow the trustees of the University of North Carolina Endowment Funds to allocate capital gains to income. This is a power private institutions would like to have for that portion of their endowment funds that has been donated for the purpose of expending the "income," either for some specific purpose or the general purpose of supporting the operations of those private institutions.

The attention of private institutions was particularly stimulated because, as just noted, the statutory framework for the University of North Carolina Endowment Funds was first established in 1971. It will be recalled that the Uniform Management of Institutional Funds Act, which would have clearly given all these powers to private colleges and universities, was promulgated in 1972.⁶⁵ It thus seemed that the quoted provisions governing the University of North Carolina Endowment Funds were patterned on the Uniform Act, which, of course, had already been drafted by 1971. There is, however, no legislative history to support this assumption. The principal reason for the lack of legislative history is that these provisions did not, in point of fact, originate in 1971. Rather, they were first enacted in 1957 as part of a legislative scheme applicable to nine state institutions, such as Western Carolina and East Carolina, and later, to two more institutions that were raised from junior college to senior college level.⁶⁶ UNC-Chapel Hill and North Carolina State University were not among these named institutions. In 1971, when the University of North Carolina was reorganized, these provisions were taken verbatim and applied to all branches

64. Law of Oct. 30, 1971, ch. 1244, § 1, 1971 N.C. Sess. Laws 1810 (codified as amended at N.C. GEN. STAT. § 116-36 (1978)).

65. See text accompanying note 8 *supra*.

66. Law of June 6, 1957, ch. 1142, § 1, 1957 N.C. Sess. Laws 1091 (codified as amended at N.C. GEN. STAT. § 116-36 (1978)).

of the consolidated University of North Carolina.⁶⁷ In sum, this seeming authorization of a total return method of reckoning income long antedates the Uniform Management of Investment Funds Act.

In 1977, the provisions of section 116-36 regulating the investment of the University of North Carolina Endowment Funds⁶⁸ were amended, clarifying the wide powers possessed by the trustees of those endowments:

(e) The trustees of the endowment fund shall be responsible for the prudent investment of the fund in exercise of their sound discretion, without regard to any statute or rule of law relating to the investment of funds by fiduciaries but in compliance with any lawful condition placed by the donor upon that part of the endowment fund to be invested.

(f) In the process of prudent investment of the fund or to realize the statutory intent of the endowment, the board of trustees of the endowment fund may expend or use interest and principal of gifts, devises, and bequests; provided that, the expense or use would not violate any condition or restriction imposed by the original donor of the property which is to be expended or used. To realize the statutory intent of the endowment fund, the board of trustees of the endowment fund may transfer interest or principal of the endowment fund to the useful possession of the constituent institution; provided that, the transfer would not violate any condition or restriction imposed by the original donor of the property which is the subject of the proposed transfer.⁶⁹

At the same time a new paragraph (g) was added, which provides:

(g) The trustees of the endowment fund shall have the power to buy, sell, lend, exchange, lease, transfer, or otherwise dispose of or to acquire (except by pledging their credit or violating a lawful condition of receipt of the corpus into the endowment fund) any property, real or personal, with respect to the fund, in either public or private transaction, and in doing so they shall not be subject to the provisions of Chapters 143 and 146 of the General Statutes; provided that, any expense or financial obligation of the State of North Carolina created by any acquisition or disposition, by whatever means, of any real or personal property of the endowment fund shall be borne by the endowment fund unless authorization to satisfy the expense or financial obligation from some other source shall first have been ob-

67. Law of Oct. 30, 1971, ch. 1244, § 1, 1971 N.C. Sess. Laws 1810 (codified as amended at N.C. GEN. STAT. § 116-36 (1978)).

68. Each branch of the University of North Carolina maintains its own separate endowment. As of June 30, 1978, the value of the UNC-Chapel Hill fund, which is the largest, was \$35,251,827.52. UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL ANNUAL FINANCIAL REP., YEAR ENDED JUNE 30, 1978, Schedule A, at 40-47.

69. Law of June 8, 1977, ch. 506, § 1, 1977 N.C. Sess. Laws 605.

tained from the Advisory Budget Commission.⁷⁰

Under the present statutory framework, it is evident that the trustees of the University of North Carolina Endowment Funds possess investment powers as broad as the trustees of any private colleges or universities could hope to have. These powers certainly are strong evidence that the legislature believes that the public policy of the state would not be offended were the courts to permit the trustees of private colleges and universities similar freedom in adopting an investment policy that in their judgment best promoted the interests of their institutions.

D. The Standard by Which the Trustees of a Private College or University in North Carolina Will Be Judged if a Particular Investment Decision Is Challenged as Imprudent

The standard by which the investment decisions of the trustees of a private college or university will be judged should they be challenged is, of course, the prudent man standard.⁷¹ We shall leave aside for the moment the question whether the trustees of private trusts, and by analogy the directors of charitable corporations, might *in practice* be required to measure up to a higher degree of care than the directors of business corporations. We are concerned here only with the articulated standard. In most states directors of business corporations are required to exercise the degree of care and diligence that an ordinarily prudent director could reasonably be expected to exercise *in a like position under similar circumstances*,⁷² whereas a trustee in most states is required to exercise "such care and skill as a man of ordinary prudence would exercise in dealing *with his own property*."⁷³ The suggestion is thus made that the reference to what the prudent man would do in the management of his own property makes the standards different. Professor Balantine, however, notes that in some states the duty of directors of business corporations is also that which an "ordinarily prudent man would exercise in the management of *his own affairs*" rather than that of an "ordinarily prudent director . . . *in a like position under similar*

70. *Id.* Under N.C. GEN. STAT. § 116-36(d) prior to these amendments, the trustees had the power to retain assets in the form in which they were received from donors and to sell any real or private property at public or private sale without regard to Chapters 143 and 146 of the General Statutes.

71. N.C. GEN. STAT. § 36A-2(a) (Cum. Supp. 1977).

72. N. LATTIN, THE LAW OF CORPORATIONS 274 (2d ed. 1971).

73. RESTATEMENT (SECOND) OF TRUSTS § 174 (1959) (emphasis added).

circumstances."⁷⁴ Ballantine reasonably concludes that "[t]his conflict of standards . . . is more apparent than real because in practical application such vague abstractions are meaningless"⁷⁵

In North Carolina, however, there is not even an apparent conflict. The directors of a North Carolina business corporation are by statute held to the standard of "good faith" and that "diligence and care which ordinarily prudent men would exercise under similar circumstances in like positions."⁷⁶ Under the new legislation on fiduciaries mentioned earlier, the obligation of trustees of trusts and other fiduciaries is that "which an ordinarily prudent man of discretion and intelligence, who is a fiduciary of the property of others, would observe as such fiduciary."⁷⁷ While there is no standard specified for the directors of non-profit corporations in general, or of charitable corporations in particular, it is inconceivable that the North Carolina courts would adopt, in the face of the statutory analogies just mentioned, any other standard than that which the ordinarily prudent man would exercise in like circumstances as the trustee or director of a charitable corporation.

It is obvious that anyone who acts in a fiduciary capacity, whether he is a director of a business corporation, a trustee of a charitable corporation, or a trustee of a private or charitable trust, must act in good faith. The question at this point is the standard by which to judge trustee liability for an investment decision that, although made in good faith, later turns sour. The case law on the practical application of the due care standard in North Carolina, however, is sparse. Case law involving directors or trustees of charitable corporations is virtually nonexistent.⁷⁸ Prior to the adoption of the North Carolina Business Corporation Act in 1955, the opinions on the liability of corporate directors sometimes spoke in terms of liability for negligence and sometimes in terms of "gross neglect."⁷⁹ And, in the few instances where liability was found, the neglect was indeed gross.⁸⁰ Liability was prem-

74. H. BALLANTINE, *BALLANTINE ON CORPORATIONS* 158-59 (rev. ed. 1946) (emphasis added).

75. *Id.* at 159.

76. N.C. GEN. STAT. § 55-35 (1978).

77. N.C. GEN. STAT. § 36A-2(a) (Cum. Supp. 1977).

78. The only case, *Fowle Mem. Hosp. v. Nicholson*, 189 N.C. 44, 126 S.E. 94 (1925), involved the question whether the trustees of a charitable corporation acted in good faith. In deciding that issue, the court referred to cases involving the duties of directors of business corporations.

79. Compare *Security Nat'l Bank v. Bridgers*, 207 N.C. 91, 176 S.E. 295 (1934) (gross neglect) and *Minnis v. Sharpe*, 202 N.C. 300, 162 S.E. 606 (1932) (gross neglect) with *Gordon v. Pendelton*, 202 N.C. 241, 162 S.E. 546 (1932) (negligence) and *Braswell v. Morrow*, 195 N.C. 127, 141 S.E. 489 (1928) (negligence).

80. See, e.g., *Minnis v. Sharpe*, 202 N.C. 300, 162 S.E. 606 (1932); *Braswell v. Morrow*, 195

ised upon serious inattention to the affairs of the corporation and similar derelictions of duty. Following the enactment of the Business Corporation Act, with specific enunciation of the "ordinarily prudent man" standard, the Supreme Court of North Carolina held that the provision was declaratory of the common law,⁸¹ and in one relatively recent case, the court of appeals actually repeated the "gross neglect, . . . mismanagement, fraud and deceit" standard articulated in some of the earlier cases.⁸² Errors of judgment, in short, have not been the basis of litigation in this state.

The same general conclusions apply with regard to the liability of private trustees, although until the recent changes were made in the statutory scheme governing fiduciaries,⁸³ the range of investments that could be made with complete safety by a trustee or similar fiduciary in North Carolina was severely limited, unless the trust instrument specifically provided to the contrary. In one of the few private trust cases,⁸⁴ a trustee was left stock in a closely held textile corporation with power "to allow such investments to remain intact or to be increased, reduced or entirely converted into . . . other investments or securities."⁸⁵ The stock was retained. Some years later the remainderman brought suit accusing the trustee of mismanagement for failure to diversify. The plaintiff produced expert witnesses who testified that a prudent investment policy required diversification, but the North Carolina Supreme Court held that, in view of the discretion granted in the trust instrument, the trustee was not obliged to diversify.⁸⁶ Admittedly, if the funds had not already been concentrated in one major investment, there may well have been some duty to diversify the trust's investments. Nevertheless, the case indicates an inclination to give private trustees, like the directors of a business corporation, the benefit of the doubt.

N.C. 127, 141 S.E. 489 (1928). In the *Minnis* case the officers of a real estate company were issuing duplicate notes on the same real estate trust indenture. The court held that, while occasional acts of fraud on the part of the corporation's officers did not show neglect on the part of the directors, the jury could infer neglect when the evidence showed the fraud was "persistently and continually practiced for substantial periods of time." 202 N.C. 300, 303, 162 S.E. 606, 607 (1932). In *Braswell*, the directors of a savings and loan association had delegated all management to the secretary-treasurer, who was also a director and who was never questioned about items noted by the auditors. 195 N.C. 127, 128, 141 S.E. 489, 490 (1928).

81. *Fulton v. Talbert*, 255 N.C. 183, 184, 120 S.E.2d 410, 411 (1961).

82. *F-F Milling Co. v. Sutton*, 9 N.C. App. 181, 184, 175 S.E.2d 746, 748, *cert. denied*, 277 N.C. 252, 175 S.E.2d 746 (1970).

83. See text accompanying note 49 *supra*.

84. *Lichtenfels v. North Carolina Nat'l Bank*, 268 N.C. 467, 151 S.E.2d 78 (1966).

85. *Id.* at 469, 151 S.E.2d at 79.

86. *Id.* at 479, 151 S.E.2d at 86.

Surely this judicial inclination to give trustees and directors substantial investment discretion would be extended to the trustees of non-profit corporations. As was well stated by a California court, a trustee of a charitable corporation such as a private college or university, who usually serves without compensation, is "held to the highest degree of honor and integrity, [but] he is not personally liable for a mistake of judgment."⁸⁷ In this regard, recall Judge Brogden's characterization of the directors of business corporations as "trustees or *quasi*-trustees."⁸⁸ The emphasis again is on honesty; second-guessing decisions made in good faith is not a task that the North Carolina courts may be expected to relish.

In defending the prudence of any particular unsuccessful investment decision, the crucial consideration should be the degree of care exercised by the trustees in the making of the decision, including a frank assessment of the risks involved, and the propriety of accepting those risks. The financial needs of the private college or university are important, as is the diversity of the investment policy involved. Also relevant is consideration of whether the investment that went sour was part of an investment policy that has been on the whole successful.⁸⁹ Finally, the investment practices of other colleges and universities throughout the country are obviously relevant. As already noted, some reference to these practices will be made in laying the groundwork for an attempt to state concrete guidelines.

Before this question of the liability of the trustees of a private college or university for a bad investment becomes a live issue, however, several events have to take place: first, there must be an unsuccessful investment decision; second, the loss would probably have to be large or the investment decision particularly unusual or seemingly rash in order to attract attention; and third, someone with the proper standing must be prepared to bring suit. The attorney general does have the required standing,⁹⁰ and in some states he is probably the only one

87. *George Pepperdine Foundation v. Pepperdine*, 126 Cal. App. 2d 154, 159, 271 P.2d 600, 604 (1954), *rev'd on other grounds*, 61 Cal. 2d 750, 394 P.2d 937, 40 Cal. Rptr. 244 (1964). The unsuccessful suit against the founder of Pepperdine College and his co-trustees sought damages for the losses suffered from certain investments.

88. See text accompanying note 41 *supra*.

89. But see RESTATEMENT (SECOND) OF TRUSTS § 213 (1959):

A trustee who is liable for a loss occasioned by one breach of trust cannot reduce his liability by deducting the amount of a gain which has accrued through another and distinct breach of trust; but if the two breaches are not distinct, the trustee is accountable only for the net gain or chargeable only with the net loss resulting therefrom.

For criticism of this position as applied to the administration of trusts, see note 62 *supra*.

90. 4 A. SCOTT, *supra* note 40, at § 391; Karst, *The Efficiency of the Charitable Dollar: An*

with such standing.⁹¹ In the absence of express judicial authority adopting this latter position in North Carolina, it is reasonable to anticipate that a member of the board of trustees who opposed the action in question or was not consulted on it might well be held to be another person with standing.⁹² Finally, if the funds or property lost could be traced to some particular donor, that person could perhaps also bring suit.⁹³ Beyond that, however, it is hard to see who would have the requisite standing.

E. General Conclusions

There are no structural limitations under North Carolina law on the range or type of investments that can be made by private colleges or universities. In other words, there is no type of potential investment that it is unlawful for a private college or university to make from its unrestricted funds merely because the investment carries a particular label.⁹⁴ Whether the investment can be made will depend on the prudence of the investment, which will in turn depend upon an examination of factors such as the overall purpose and strategy of the investment and, of course, the degree of risk. Most, if not all, investments in commodities, for example, may be inappropriate for a private college or university, but only because the degree of risk may be too high to be justified under normal circumstances, not because of the label "commodities."

Unfulfilled State Responsibility, 73 HARV. L. REV. 433, 451 (1960). See, e.g., N.C. GEN. STAT. § 36A-48 (Cum. Supp. 1977).

91. See, e.g., *Ames v. Attorney General*, 332 Mass. 246, 250-51, 124 N.E.2d 511, 513-14 (1955); *Judkins v. Hyannis Pub. Library Ass'n*, 302 Mass. 425, 427, 19 N.E.2d 727, 729 (1939).

92. See, e.g., RESTATEMENT (SECOND) OF TRUSTS § 391 (1959).

93. See G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 415 (rev. 2d ed. 1977); 4 A. SCOTT, *supra* note 40, § 391 at 3013.

94. Much of the same investment freedom would seem applicable to restricted funds, or what I have called "regular endowment." Caveats arise only because these funds, which have typically been given to the institution in order that the "income" generated may be expended for some one or more purposes, might not, under North Carolina law, be amenable to administration under a total return method of accounting. See text accompanying notes 6-12 *supra*. Accordingly, depending upon the purpose for which the restricted funds were given to the institution, it may not be possible to place them in investments that do not generate any substantial current income.

III. OTHER MORE GENERAL SOURCES OF GUIDANCE ON THE RANGE OF ALLOWABLE INVESTMENT POLICIES OF PRIVATE COLLEGES AND UNIVERSITIES

A. *The Uniform Management of Institutional Funds Act*

As already noted,⁹⁵ twenty-five states and the District of Columbia have now adopted the Uniform Management of Institutional Funds Act. While North Carolina thus far has not, it does not seem implausible that a North Carolina court called upon to adjudicate the legitimacy of investments made by North Carolina colleges and universities would find it helpful to consider the range of investments permitted under the Act.

Section four of the Uniform Management of Institutional Funds Act gives the governing board of an institutional fund the following investment authority:

In addition to an investment otherwise authorized by law or by the applicable gift instrument, and without restriction to investments a fiduciary may make, the governing board, subject to any specific limitations set forth in the applicable gift instrument or in the applicable law other than law relating to investments by a fiduciary, may:

(1) invest and reinvest an institutional fund in any real or personal property deemed advisable by the governing board, whether or not it produces a current return, including mortgages, stocks, bonds, debentures, and other securities of profit or nonprofit corporations, shares in or obligations of associations, partnerships, or individuals, and obligations of any government or subdivision or instrumentality thereof;

(2) retain property contributed by a donor to an institutional fund for as long as the governing board deems advisable;

(3) include all or any part of an institutional fund in any pooled or common fund maintained by the institution; and

(4) invest all or any part of an institutional fund in any other pooled or common fund available for investment, including shares or interests in regulated investment companies, mutual funds, common trust funds, investment partnerships, real estate investment trusts, or similar organizations in which funds are commingled and investment determinations are made by persons other than the governing board.⁹⁶

In the exercise of this authority, the members of the governing board are required by section six of the Act to "exercise ordinary business care and prudence under the facts and circumstances prevailing at the

95. See text accompanying note 9 *supra*.

96. UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT § 4.

time of the action or decision."⁹⁷ In complying with this standard, the members of the governing board are directed

[to] consider long and short term needs of the institution in carrying out its educational, religious, charitable, or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.⁹⁸

On their face, the provisions of the Uniform Management of Institutional Funds Act provide a great deal of discretion to the trustees of private colleges and universities operating in states that have adopted that Act. Admittedly, the Act speaks in fairly general terms. A court confronted with a challenge to some specific investment decision would understandably like to have more detailed guidance. Fortunately, such guidance is available. The provisions in the Uniform Act relating to the care and prudence required of the trustees of institutional funds were patterned after the Treasury Regulations issued under the authority of section 4944 of the Internal Revenue Code,⁹⁹ which imposes certain taxes upon private foundations, as defined in section 509 of the Internal Revenue Code,¹⁰⁰ if they engage in transactions that "jeopardize" a charitable purpose.¹⁰¹ Accordingly, it is helpful to consider those regulations in some detail.

B. The Treasury Regulations Issued Under Section 4944 and Other Federal Sources of Guidance

Under the regulations interpreting section 4944, foundation managers are deemed to have jeopardized the charitable purpose of their foundation if, in making investments, they "have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes."¹⁰² Although the typical private college or university is not a private foundation to which this tax is applicable, the Treasury

97. *Id.* § 6. In Massachusetts, the standard is "that degree of diligence, care and skill which prudent men would ordinarily exercise under similar circumstances in a like position." MASS. ANN. LAWS, ch. 180A, § 8 (Law. Co-op 1977). Several other states likewise omit any reference to "business care."

98. UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT § 6.

99. I.R.C. § 4944; Treas. Reg. § 53.4944 (1973).

100. I.R.C. § 509. Both § 4944 and § 509 were added by the Tax Reform Act of 1969, Pub. L. No. 91-172, § 101, 83 Stat. 496.

101. Treas. Reg. § 53.4944 (1973).

102. Treas. Reg. § 53.4944-1(a)(2)(i) (1979).

Regulations are worth close examination because they go into considerable detail on what are proper investments for prudent managers of private foundations and because the care and prudence provisions of the Uniform Management of Institutional Funds Act, which do govern trustees of private colleges and universities in states in which the Act has been adopted, were patterned after these Treasury Regulations. In assessing the standard of care and prudence for foundation managers the Regulations list the following factors:

the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return). . . .¹⁰³

The Regulation later gives specific examples of when the standard of care has or has not been satisfied by the foundation managers. One example indicates that under some circumstances a private foundation can invest in venture capital situations without jeopardizing any of its charitable purposes and thereby incurring additional federal taxes.¹⁰⁴

103. *Id.* The regulation continues:

The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an *investment by investment basis*, in each case taking into account the foundation's portfolio as a whole. *No category of investments shall be treated as a per se violation of section 4944.* However, the following are examples of types or methods of investment which will be closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence: Trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of "puts," and "calls," and "straddles," the purchase of warrants, and selling short. The determination whether the investment of any amount jeopardizes the carrying out of a foundation's exempt purposes is to be made as of the time that the foundation makes the investment and not subsequently on the basis of hindsight. Therefore, once it has been ascertained that an investment does not jeopardize the carrying out of a foundation's exempt purposes, the investment shall never be considered to jeopardize the carrying out of such purposes, even though, as a result of such investment, the foundation subsequently realizes a loss. . . .

Id. (emphasis added).

104. The provisions for determining the standard of care for investments by foundation managers are illustrated by the following examples:

Example (1). A is a foundation manager of B, a private foundation with assets of \$100,000. A approves the following three investments by B after taking into account with respect to each of them B's portfolio as a whole: (1) an investment of \$5,000 in the common stock of corporation X; (2) an investment of \$10,000 in the common stock of corporation Y; and (3) an investment of \$8,000 in the common stock of corporation Z. Corporation X has been in business a considerable time, its record of earnings is good and there is no reason to anticipate a diminution of its earnings. Corporation Y has a promising product, has had earnings in some years and substantial losses in others, has never paid a dividend, and is widely reported in investment advisory services as seriously undercapitalized. Corporation Z has been in business a short period of time and manufactures a product that is new, is not sold by others, and must compete with a well-established alternative product that serves the same purpose. Z's stock is classified as a high-risk investment by most investment advisory services with the possibility of sub-

Likewise, another example indicates that investments in unimproved land can also, under appropriate circumstances, meet the prudent man standard imposed by the Treasury Regulations.¹⁰⁵

Although these regulations specifically state that neither section 4944 nor the regulations themselves shall "exempt or relieve any person from compliance with any Federal or State law imposing any obligation, duty, responsibility, or other standard of conduct with respect to the operation or administration of an organization or trust to which section 4944 applies,"¹⁰⁶ one would expect that in a state that has adopted the Uniform Act a court would find the Treasury Regulations and the examples they set out quite persuasive in determining what the standard of conduct is under the Act for investments made by trustees of charitable corporations. It furthermore does not seem implausible to expect that a state such as North Carolina, which has yet to adopt the Act but whose common law seems to accord to the trustees of private colleges and universities the same broad powers, would also be prepared to look to the Treasury Regulations for guidance in a case in-

stantial long-term appreciation but with little prospect of a current return. A has studied the records of the three corporations and knows the foregoing facts. In each case the price per share of common stock purchased by B is favorable to B. Under the standards of paragraph (a)(2)(i) of this section, the investment of \$10,000 in the common stock of Y and the investment of \$8,000 in the common stock of Z may be classified as jeopardizing investments, while the investment of \$5,000 in the common stock of X will not be so classified. . . .

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

Id. § 53.4944-1(c).

105.

Example (3). D is a foundation manager of E, a private foundation with assets of \$200,000. D was hired by E to manage E's investments after a careful review of D's training, experience and record in the field of investment management and advice indicated to E that D was well qualified to provide professional investment advice in the management of E's investment assets. D, after careful research into how best to diversify E's investments, provide for E's long-term financial needs, and protect against the effects of long-term inflation, decides to allocate a portion of E's investment assets to unimproved real estate in selected areas of the country where population patterns and economic factors strongly indicate continuing growth at a rapid rate. D determines that the short-term financial needs of E can be met through E's other investments. Under the standards of paragraph (a)(2)(i) of this section, the investment of a portion of E's investment assets in unimproved real estate will not be classified as a jeopardizing investment and neither D nor E will be liable for an initial tax on such investment.

Id.

106. *Id.* § 53.4944-1(a)(2)(i).

volved the legality of some specific investment decision of the trustees of a private college or university organized under the laws of that particular state. This is particularly likely in North Carolina because, as noted,¹⁰⁷ those private foundations defined by section 509 of the Internal Revenue Code that are governed by the Nonprofit Corporation Act of North Carolina are by North Carolina statute prohibited from engaging in investments that will lead to the imposition of additional federal taxes unless the institution specifically states in its charter its intention not to be so bound. This certainly indicates a legislative acceptance that the Treasury Regulations issued under section 4944 are a valid source of guidance for the North Carolina courts. There is no reason to conclude that this guidance should be confined to cases involving private foundations and not extended to similar investment decisions of private colleges and universities, which, while not typically private foundations, are nevertheless, like private foundations, typically organized as nonprofit corporations.

Another area of federal guidance might be the final regulations recently promulgated by the Department of Labor under section 404(a) of the Employee Retirement Income Security Act of 1974 (ERISA).¹⁰⁸ That section of the Act lays down a prudent man standard to govern the fiduciary duties of employee benefit fund trustees.¹⁰⁹ In explaining its regulations, the Department noted that "the common law of trusts . . . should . . . not be mechanically applied to employee benefit plans."¹¹⁰ The Department also stated its view "that an investment reasonably designed—as part of the portfolio—to further the purposes of the plan, and that is made upon appropriate consideration of the surrounding circumstances, should not be deemed to be imprudent merely

107. See note 32 and accompanying text *supra*.

108. 44 Fed. Reg. 37,221 (1979) (to be codified in 29 C.F.R. § 2550.404a-1).

109. 29 U.S.C. § 1104 (1976). The pertinent provisions of § 1104(a)(1) provide:

[A] fiduciary shall discharge his duties with respect to a plan solely in interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and
(ii) defraying reasonable expenses of administering the plan;

(B) with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of the title.

110. 44 Fed. Reg. 37,222 (1979).

because the investment, standing alone, would have, for example, a relatively high degree of risk.”¹¹¹ Finally, the Department declined to follow the suggestion of those who submitted comments while the regulations were in the draft stage that the Department take a position as to the legality under ERISA of certain types of investments that were not viewed with favor under the traditional trust law. Such investments included “investments in small or recently formed companies, or non-income producing investments that are not securities (such as, for example, certain precious metals and objects of art).”¹¹² In declining to take such a position, the Department noted its belief that the “‘prudence’ rule does not require that every plan investment produce current income under all circumstances” and reiterated its position that “the universe of investments permissible under the ‘prudence’ rule is not necessarily limited to those permitted at common law” by the law of trusts.¹¹³ The Department refused, however, to promulgate a legal list. It closed its preamble to the new regulation by declaring merely that “the risk level of an investment does not alone make the investment *per se* prudent or *per se* imprudent.”¹¹⁴

The final regulations go on to lay down a number of considerations that the fiduciary of an employee benefit fund must take into account in formulating investment policy. Among these considerations, in addition to the merits of any individual investment and its furtherance of the purposes of an investment plan, are: (1) the composition of the portfolio with regard to diversification; (2) the liquidity and current return of the portfolio relevant to the anticipated cash flow requirements of the employee benefit plan; and (3) the projected return of the portfolio relative to the funding objectives of the plan.¹¹⁵ Given this relative investment freedom federal law is prepared to give to fiduciaries managing employee benefit plans, North Carolina courts should be prepared to grant at least as much, if not more, freedom to the trustees of private colleges and universities who do not have nearly the same level of fiduciary responsibility to any specific individuals as do the managers of employee benefit plans.

111. *Id.* at 37,224.

112. *Id.*

113. *Id.* at 37,225.

114. *Id.*

115. *Id.* (to be codified in 29 C.F.R. § 2550.404a-1(b)(2)(B)).

C. *Contemporary Investment Practices of Major Private Colleges and Universities*

Currently, the range of investments undertaken by major American private colleges and universities is becoming increasingly diverse in an attempt to protect endowments from erosion by inflation. Investment in fixed-income securities and in common stock continue to figure prominently in investment strategies. Columbia University, whose ownership of the land under Rockefeller Center is common knowledge, has long maintained a substantial portion of its endowment in real estate. Other private institutions are increasingly turning to similar investments. Stanford has, for example, since the early 1950s, owned a shopping center that it helped develop on university-owned property.¹¹⁶ Yale has now embarked on a plan to move between \$50 to \$60 million, or roughly ten percent, of its endowment into real estate.¹¹⁷ As part of this strategy, in December 1978, the university purchased a half-interest in the Corning Glass Building in New York City for \$15 million.¹¹⁸ In North Carolina, Duke has more recently announced that it has formed a partnership with two Raleigh developers to develop and operate a \$4 million office building in Raleigh.¹¹⁹ The University is a limited partner in this enterprise, whose principal tenant will be IBM. Furthermore, as has already been noted,¹²⁰ Duke purchased over 1,000 acres of undeveloped land north of Raleigh in September 1978. Ranging beyond real estate, an expanding number of private colleges and universities, including Harvard,¹²¹ have started to invest in venture capital situations.

Private colleges and universities have also become actively involved in the trading of financial instruments. For example, it is a common practice for private colleges and universities to sell covered options. That is, an institution will sell, through brokers, call options on stock that it has in its portfolio. The options usually will have a striking price at or above the current market price, and of course the purchaser will have to pay a certain amount for the option to buy the securities at the striking price on or before some later date, ninety days being a frequent period. This is a relatively risk-free form of financial

116. FORTUNE, Dec. 18, 1978, at 70.

117. N.Y. Times, Dec. 10, 1978, at 69, col. 1.

118. *Id.*

119. Durham Morning Herald, July 17, 1979, § B, at 14.

120. See text accompanying note 21 *supra*.

121. See N.Y. Times, July 30, 1978, § 3, at 3, col. 5.

transaction. If the price of the underlying stock does not rise sufficiently to justify the exercise of the option, then the institution retains the underlying shares and pockets the money it receives for selling the option.¹²² If the underlying shares appreciate sufficiently to make the option worth exercising then the institution would receive the exercise price in addition to the premium it has already received for selling the option. Admittedly, the institution will have lost the additional capital gain that it would have realized had it waited to sell the underlying shares. It is therefore in the interest of the institution to sell covered options only on securities that its financial advisers do not expect will have substantial short-term appreciation.

Other market strategies followed by private colleges and universities include securities lending.¹²³ This typically involves lending securities to brokers who need the securities for the purpose of delivering securities sold short or for delivering securities the broker is under an obligation to deliver but has failed to receive from its customers.¹²⁴ The loans are usually collateralized by cash in amounts not less than 100 percent of the sales price of the security on the most recent trading day. The advantage to the institution is that it continues to receive any dividends on the underlying securities and can invest the cash collateral in short-term Treasury notes. When the collateral is not cash but other marketable securities, the lending institution will usually also charge the borrower of the securities interest on the loan. Whatever the form of the collateral, the typical arrangement provides for increases in collateral if the loaned securities appreciate in value. When the loan comes due, the borrower is obliged to return either the same or equivalent security certificates. The only risk is that, through the insolvency of the broker, securities that have appreciated in value above the

122. If the underlying shares begin to drop substantially in value the educational institution may sell the underlying shares provided that it protects itself against a sudden appreciation of the shares prior to expiration of the option by either entering a buy order at an appropriate price, presumably less than the striking price of the option it has sold, or by buying an option to purchase a similar quantity of the underlying shares, again at presumably a striking price less than the striking price of the call option it initially sold. For a statement that it is lawful for private colleges and universities to sell covered options, see Wheeler, *supra* note 62, at 215. Moreover, the Comptroller of the Currency has declared that writing covered call options is proper for the trust departments of national banks. See Thayer, *Here They Come, Ready or Not: New Forms of Option Investing*, 116 Tr. & Est. 811 (1977). Thayer argues that even the buying of call options, the buying of puts, and the selling of naked puts are, in appropriate circumstances, proper investments for trust departments, and are increasingly so regarded by trust officers, despite the Comptroller's doubts as to their propriety. *Id.* at 813-14.

123. Harvard is reported as regularly lending between \$60 million to \$90 million of securities at any one time. N.Y. Times, July 30, 1978, § 3 at 3, col. 6.

124. For a description of the process, see *id.*; Wheeler, *supra* note 62, at 213-15.

value of the collateral will not be returned.¹²⁵

In sum, a private college or university can pursue a fairly broad long-term and short-term investment strategy without running the risk that a court will later find the decision to have been imprudent merely because the institution in question is the only one engaging in the particular practice. Almost any investment strategy that can be defended, on its own merits, as prudent will probably be found to have been followed by a number of responsible and well-managed private colleges and universities.

IV. POSSIBLE CAUTIONARY GUIDELINES FOR NORTH CAROLINA PRIVATE COLLEGES AND UNIVERSITIES

We have concluded that under North Carolina law it is impossible to assert that any particular type of otherwise lawful investment is *per se* improper for the trustees of a private college or university operating under the ordinarily prudent man standard. The fact remains, however, that there is little concrete law on what is a prudent investment and no law in North Carolina. Accordingly, the following, perhaps overly conservative, cautionary guidelines are suggested for consideration by North Carolina institutions preparing to adopt a more aggressive investment posture.

A. *Commodities*

Commodity trading should probably be avoided. While the better view, such as that contained in the Treasury Regulations previously quoted, is that no category of investment is *per se* improper merely because of its label, the fact remains that very few private colleges or universities have ever engaged in such transactions.¹²⁶ Furthermore, the label "commodities" is an emotionally charged one; in the minds of many people it conjures up only one meaning—"speculation." Under these circumstances, justifying an investment in commodities that proved unsuccessful might be difficult, even if the institution showed that it had obtained the advice of the most sophisticated experts who

125. In *Securities Investor Protection Corp. v. Executive Securities Corp.*, 423 F. Supp. 94 (S.D.N.Y. 1976), *aff'd per curiam*, 556 F.2d 98 (2d Cir. 1977), it was held that a securities lender—in that case Yale University—was not a "customer" of a broker and thus not entitled to the protection of the Securities Investor Protection Act of 1970.

126. In 1975, Boston University briefly put a sum equal to approximately 1.5% of its endowment into commodities. Although the University made a profit on its commodity dealings, it discontinued that type of investment. See *FORTUNE*, Dec. 18, 1978, at 70.

devoted all of their time to managing the institution's commodity investments.

B. Objet d'Art

There is no question that, in recent years, paintings, antique porcelain, and other types of art have appreciated at astounding rates. Nevertheless, one would be extremely hesitant to suggest that any substantial amount of a private college or university's endowment funds should be invested in *objet d'art*. This kind of investment, in addition to producing no current return, is too illiquid and too dependent upon subjective considerations. Holding on to art donated to an educational institution is, of course, another question. All private colleges and universities do that and one would not wish to suggest that there is anything improper in so doing.

C. Real Estate

It would be hard to argue that unimproved land cannot be a prudent investment under some circumstances. Obviously, as with any investment, adequate investigation and assessment of the long- and short-run risks and the possibilities of gain are essential. Unimproved real property, however, is marked by a lack of liquidity and the absence of any current income, while the investing institution remains continually liable for property taxes. A cautious man would, therefore, be hesitant about committing too great a percentage of the assets of a private college or university to these investments. *A priori*, it would seem that, the smaller the size of the endowment, the smaller the percentage of the endowment's assets should be tied up in unimproved land. Naturally, in deciding how much of an endowment's assets can be invested in unimproved land, the institution's need for current income must be a paramount consideration.

Improved, income-producing real estate is of course another matter. While it would probably be imprudent to ignore the need for some diversity in the investment policies of a private college or university by investing all of such an institution's funds in real estate, certainly the careful investment of a large portion of an institution's funds in real estate—either by outright ownership or the provision of first mortgage loans—would not be a decision that would, on its face, seem suspect. Leveraged situations are another question. One could make a strong argument for treating such situations, particularly if they are very high-

ly leveraged,¹²⁷ as similar to venture capital situations, a subject that will be discussed in the next section.

D. Venture Capital Situations

With appropriate documentation and competent professional advice it would be hard to conclude that these investments are *per se* imprudent. Certainly, many universities are now engaged in some venture capital investments. The crucial question is how much of a private college or university's assets can be invested in such situations. Although it is difficult to suggest definitive guidelines, the size of an institution's endowment funds, as well as that institution's overall financial position, will affect how much can be prudently invested in venture capital situations. An institution that is in good financial shape and has a large endowment may be in a position to commit amounts that are more than proportionately larger than those a more hard-pressed and less well-endowed institution would be justified in committing. Committing more than 10 percent of an institution's assets to venture capital situations would nevertheless appear to be risky. Possibly commitment of over 5 percent of an institution's funds to venture capital situations would carry a heavy burden of justification, as would commitment of over 2.5 percent of the institution's funds to any particular venture capital situation.

A final difficult decision is whether a private college or university should make its own venture capital investment decisions or should invest the money in an investment company that goes out and finds promising situations and then makes the investments largely on its own judgment. There is perhaps something to be said, particularly when investments of, say, over \$250,000 are involved, for an educational in-

127. The following is an example of a leveraged investment in improved real estate. Suppose a university contributes capital to become a limited partner in a limited partnership that in turn secures a large amount of financing from an institutional lender to enable the partnership to purchase a shopping center as an investment. The lender will, of course, insist on holding a mortgage on the real estate. Although this is an investment in improved real estate, it is more analogous to a venture capital situation because the shopping center must return sufficient cash to meet the annual debt service. The greater the leverage (the percentage of the purchase price financed by the loan), the greater the debt service and the more dependent the success of the investment on sufficient annual cash return, and the greater the risk of total loss if the mortgage holder forecloses. These risks will be increased if, to finance the deal, second and third mortgages, at high interest rates, are given—as is sometimes the case in highly leveraged situations. If, on the other hand, the college or university buys improved real estate for cash, it will not run these risks. It would seem overly severe to conclude that a college or university could never buy real estate except for cash. If the educational institution makes a substantial equity investment in the property and the reasonably expected income easily covers the debt service on the mortgage and other fixed charges, such an investment would not appear particularly risky.

stitution's either directly making the investment or, if the investment is made through an independent investment company, at least providing terms of reference that are very specific and detailed. Caution must also be exercised in any venture capital situation where an educational institution is a limited partner and the general partners have significantly less capital invested in the enterprise, in proportion to their share of the gains, than the limited partners. Beyond this, however, it seems difficult to generalize. As with most investment decisions, the specific facts and circumstances surrounding any particular investment will be the most crucial consideration.

CONCLUSION

The uncertain future of the American economy imposes many challenges to the continuing viability of private colleges and universities. To meet the challenges confronting these institutions, their trustees will need to display uncommon foresight, wisdom and ability. The purpose of this Article has been to show that there is nothing in North Carolina law that will impose any artificial constraints upon the ability of trustees to meet these very serious challenges.

