Technical Assistance Legal Center

Educational Foundations and Endowments
Legal Standards for Tobacco Divestment
April 2001

There is a growing movement to encourage large institutions to divest from tobacco holdings. Recently, attention has begun to focus on endowment funds held by educational institutions. This memo discusses the legal issues of tobacco divestment, the statutory and case law that governs educational foundations and endowments in California, and their legal authority to divest their tobacco holdings and to avoid such investments in the future. It explains the legal issues that bear on the divestment effort, and concludes that members of the governing board of an educational foundation or endowment have the authority to divest from tobacco stock and avoid future tobacco investments, subject to the legal boundaries discussed below.

1. Types of Educational Foundations & Endowments

Colleges and universities hold different pools of money for different purposes. A college or university can manage an endowment that is part of the university (e.g., Stanford University's endowment), or an independent foundation can be established to support the university's function (e.g., the UC Berkeley Foundation). Either way, an educational foundation manages money that has been given as a gift to the college or university. A foundation is generally organized as a nonprofit public benefit corporation for educational purposes, and is exempt from federal income taxation under Internal Revenue Code section 501(c)(3) and exempt from state income taxation under California Revenue and Taxation Code section 23701. As part of its functions, an educational foundation may manage separate pools of money that are called endowments. These endowments are established by donors and generally do not exist as independent legal entities. Donations to an endowment are never spent, and the income generated by investments is used for a particular educational purpose.[1] The University of

[1] "An endowment fund is a fund whose donor has stipulated that the fund principal must remain inviolate and that only income may be expended. In accepting endowment funds, the University is legally bound to keep the principal intact and to comply with donor restrictions governing the use of income." University of California, *Development Policy Manual*, ch. III, F.1 (Jan. 1989) *available at* <http://www.ucop.edu/ucophome/policies/devpol/dpa3f1.html>.

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California, for example, requires a minimum gift of $10,000 to establish an endowment fund.[2]

2. Fiduciary Duties

Members of the governing board owe certain duties to manage the money held by the foundation or endowment in a sound way (the duty of prudence), and not to let management decisions be affected by conflicts of interest (the duty of loyalty). These duties are imposed upon board members so that the money is most wisely invested and is used to solely benefit the educational institution.

A. Duty to Prudently Invest Foundation and Endowment Money

Members of the governing board of both private and public institutions, have a duty to prudently invest foundation and endowment money. This means that investment decisions must be based on sound investment principles, and be expected to maximize the rate of return, while minimizing the risk that the investment will fail. This is called the risk-adjusted rate of return. These principles apply to California educational foundations and endowments and are found in various California statutes and cases, discussed below.

Board members do not breach the duty of prudence when they decide to divest from tobacco stock if they make an informed decision that investing in tobacco stock is unwise either because: 1) the anticipated risk and return associated with tobacco stock is worse than for other investments, or 2) the anticipated risk and return of tobacco stock is no better or no worse than alternative investments.[3]

The duty to make prudent investments prevents members of the governing board from pursuing divestment if such action would detrimentally affect the risk-adjusted return of the institution's investments. As part of the duty of prudence, board members must maintain a properly diversified portfolio.[4] Since tobacco stock usually represents a small portion of an educational foundation's portfolio, the duty to diversify would not be breached by eliminating such a small portion of the portfolio.[5]

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[2] University of California, *Development Policy Manual*, ch. III, F.1 (Jan. 1989) *available at* <http://www.ucop.edu/ucophome/policies/devpol/dpa3f1.html>.

[3] *See* Lewis D. Solomon and Karen C. Coe, *Social Investments by Nonprofit Corporations and Charitable Trusts: A Legal and Business Primer for Foundation Managers and Other Nonprofit Fiduciaries*, 66 UMKC L. REV. 213, 250 (1997); Lanoff, *supra* note 19, at 4 ("If the analysis whether it is prudent to invest in or hold a security yields an uncertain or positive result, a fiduciary may lawfully sell the security if it is not imprudent to do so. Under such circumstances, a fiduciary may lawfully choose to divest, provided that a financial and economic analysis performed by investment professionals uncovers a number of potential investment opportunities that are ostensibly equally advantageous from an economic perspective. In this way a fiduciary may lawfully implement the divestment plan because it satisfies fiduciary requirements of loyalty to plan participants . . . and prudence.") (citations omitted).

[4] *See* Beach v. Carter, 15 Cal. 3d 623, 634, n.9 (1975) (treating the duty to diversify as part of the duty of prudence).

[5] *See* Board of Trustees v. Baltimore, 317 Md. 72 (1989), discussed *infra* at p. 6.

Board members have a duty to become informed about investments, and seek expert opinions if the circumstances dictate that this would be a prudent course of action.[6] Once members of a governing board decide to sell tobacco stock, they should document the reasons supporting the board's decision,[7] and it should engage in periodic review of the investment portfolio as a whole to confirm that the information on which it relied is still correct.[8]

Board members' decisions are judged based on the information that was known at the time an investment decision is made.[9] This means that even if an investment proves to be unprofitable at a later date, the decision to invest will not be found to be imprudent if, at the time the investment was made, it promised an acceptable risk-adjusted rate of return.

B. <u>Duty of Loyalty</u>

In addition to the duty of prudence, board members have a duty of loyalty. This duty broadly prohibits board members from engaging in self-dealing (making a decision from which they personally benefit).[10] In considering whether to avoid tobacco stock, the board is prohibited from taking any action that would compromise the board's mission to maximize risk-adjusted return. So long as tobacco divestment does not supplant the foundation's primary purpose, the duty of loyalty is not breached.

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[6] CAL PROB. CODE § 18505(b) empowers the governing board of an endowment or foundation to "[c]ontract with independent investment advisors, investment counsel or managers, banks, or trust companies . . . ." *See also* CAL PROB. CODE § 16502 ("A trustee may delegate investment and management functions as prudent under the circumstances."); *cf*. Katsaros v. Cody, 744 F.2d 270 (2d Cir. 1984) (trustees breached duty of prudence where they failed to seek outside assistance and instead relied exclusively on the representations of the borrower).

[7] *See* James D. Hutchinson & Charles G. Cole, *Legal Standards Governing Investment of Pension Assets for Social and Political Goals*, 128 Penn. L. Rev. 1340, 1383 (1980); Troyer et al., *Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions, and Pension Funds*, 74 Geo. L.J. 127, 145 (1985).

[8] *See* Katsaros v. Cody, 744 F.2d 270, 276 (2d Cir. 1984) (finding fault with trustees who received only sporadic, incomplete information from the borrower, and failed to examine the information that was provided), Whitfield v. Cohen, 682 F. Supp. 188, 197 (S.D.N.Y. 1988) ("Cohen's failure to apprise himself of the nature of the investments made by Penvest on behalf of the Plan and his acquiescence in Penvest's failure to account to the Plan establish a breach of his fiduciary obligation to monitor the performance of the Plan's investments."); *see also* Troyer, *supra* note 18, at 146; Memorandum from Ian D. Lanoff to the California State Teachers Retirement System's Investment Committee regarding Points Concerning Investment and Divestment of Plan Assets in Conformity with Fiduciary Principles (March 24, 2000) at 5 (on file with the Technical Assistance Legal Center, 510.444.8252).

[9] *See* CAL PROB. CODE § 16051 ("Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight."). *See also* Beach v. Carter, 15 Cal. 3d 623 (1975) (Despite a decline of stock held by the executor from $16/share to $6/share, the executor had not breached its duty of prudence.); Day v. First Trust & Savings Bank, 47 Cal. App. 2d 470, 477 (1941).

[10] *See generally* Cal. Corp. § 16002 (2000).

3. Statutes

Two California statutes apply to educational foundations and endowments: the Uniform Management of Institutional Funds Act and the Nonprofit Public Benefit Corporation Law. These statutes impose similar duties on board members.

A. Uniform Management of Institutional Funds Act

Educational foundations and endowments in California are governed by the Uniform Management of Institutional Funds Act (UMIFA).[11] UMIFA applies to educational foundations and endowments based on UMIFA's definition of "institution":

> [A]n incorporated or unincorporated organization organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes, or a governmental organization to the extent that it holds funds exclusively for any of these purposes.[12]

This definition applies to public and private university endowments and foundations, such as Stanford University's endowment, the University of California, Berkeley Foundation, and the Foundation of California State University, Monterey Bay.

The investment decisions by these institutions are governed by a standard of care which requires prudent investment practices judged at the time of the decision and judged by what an average board member knows about investment matters.[13] Members of the governing board[14] of educational endowments and foundations must fulfill this standard of care (often called the prudent person standard, or the duty of prudence,

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[11] CAL. PROB. CODE §§ 18500-18509.

[12] CAL. PROB. CODE § 18501(e).

[13] "When investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing property, appropriating appreciation, and delegating investment management for the benefit of an institution, the members of the governing board shall act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the institution. In the course of administering the fund pursuant to this standard, individual investments shall be considered as part of an overall investment strategy." CAL. PROB. CODE § 18506(a).

[14] UMIFA defines the members of the governing board as "the body responsible for the management of an institution or of an institutional fund." CAL. PROB. CODE § 18501(c).

discussed above) in making investment decisions.[15] The University of California Regents have adopted this standard of care,[16] as have the nine UC campus foundations.[17]

B. Nonprofit Public Benefit Corporation Law

Many educational foundations are organized and operated as California nonprofit public benefit corporations.[18] If a foundation is organized pursuant to California's Nonprofit Public Benefit Corporation Law,[19] board members' investment decisions also are governed by the standard of care in California Corporations Code Section 5231:[20]

> A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests

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[15] The University of California vests in each campus foundation's governing board the responsibility over how money is to be invested. *Administrative Guidelines for Campus Foundations*, University of California Office of the Senior Vice President--Business and Finance, July 17, 2000, *available at* <http://www.ucop.edu/ucophome/coordrev/policy/7-17-00att.html> ("Responsibility for governance of the Foundation, including investment of gifts and endowments, is vested in its governing board.").

[16] The Regents of the University of California, March 20, 1998 Board Hearing Minutes, *available at* <http://www.ucop.edu/regents/minutes/9798/board398.pdf>. See also The University of California Development Policy Manual, ch. VI, *available at* <http://www.ucop.edu/ucophome/policies/devpol/dpa6e.html>. The University of California's guidelines for campus foundations dictate a specific policy consistent with UMIFA:

> "Financial activities of a Campus Foundation shall be administered and reported in accordance with prudent business practices and generally accepted accounting principles.
> . . .
> "A Campus Foundation may hold and invest endowments and funds functioning as endowments on a long-term basis. Such investments must be consistent with the terms of the gift instrument. Investment operations shall be conducted in accordance with prudent, sound practices to ensure that gift assets are protected and enhanced and that a reasonable return is achieved, and with due regard for the fiduciary responsibilities of the Foundation's governing board. The Treasurer of The Regents shall review investment procedures and results annually and report the findings to The Regents."

Administrative Guidelines for Campus Foundations, University of California Office of the Senior Vice President--Business and Finance, July 17, 2000, *available at* <http://www.ucop.edu/ucophome/coordrev/policy/7-17-00att.html>. The University of California requires that donations to support groups, campus foundations, campus alumni associations and affiliated organizations must be irrevocably dedicated for the benefit of the University or one of its campuses. The Regents of the University of California, *Policy on Support Groups, Campus Foundations and Alumni Associations* (approved Sept. 15, 1995), *available at* <http://www.ucop.edu/regents/policies/6078.html>.

[17] Regents' Briefing, A Recap of Actions Taken by University of California Regents at the March 19 and 20 [1998] meeting at UC San Francisco, available at <http://www.ucop.edu/ucophome/commserv/regmarch98.html>.

[18] Each University of California campus has one campus foundation which must be organized and operated as a California nonprofit public benefit corporation. *Administrative Guidelines for Campus Foundations*, University of California Office of the Senior Vice President--Business and Finance, July 17, 2000, *available at* <http://www.ucop.edu/ucophome/coordrev/policy/7-17-00att.html>.

[19] CAL. CORP. CODE §§ 5110-6910.

[20] *See also* CAL. CORP. CODE § 5240.

of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

This standard is similar to and meant to coexist with the prudence standard in California's UMIFA.[21]

4. Case Law Interpreting UMIFA and Fiduciary Duties

To date, no reported cases interpret California's UMIFA. In New Jersey, a superior court upheld as prudent the stringent investment screens of a foundation under both New Jersey's UMIFA and the state's law governing nonprofit corporations.[22] In *Johnson v. Johnson*, the foundations' investment managers (the foundations' founder and his son, both of whom had little investment expertise) screened out companies from possible investment that did not meet certain financial criteria, leaving only a small proportion of eligible companies. The initial screen eliminated 80% of all common stocks on the market, and 90% of the remaining stocks were eliminated by a second screen.[23] This investment strategy caused the foundation's financial performance to underperform the S&P 500. A New Jersey court held that the investment strategy was reasonable despite the subsequent losses, and therefore the investment managers did not breach the prudent person standard.[24] *Johnson* provides persuasive support to board members considering tobacco divestment so long as divestment is part of an overall investment strategy that is reasonably expected to meet the foundation's risk-adjusted return expectations. Indeed, the investment strategy in *Johnson* yielded an investment portfolio that was grossly underdiversified. It would be rare if an educational foundation's tobacco stock would account for more than a very small portion of the investment portfolio. Assuming that the portfolio was prudently invested separate from the tobacco investments, replacing that small portion with other investments would not breach the duty of prudence, especially if the tobacco stock was replaced with investments of similar expected risk-adjusted return.

5. Legal Standards Applied to Divestment Actions

A number of cases are discussed below that have ruled either on divestment efforts or efforts to apply non-financial considerations to investment

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[21] *See* CAL. CORP. CODE § 5240(e) ("Nothing in this section shall be construed to preclude the application of the Uniform Management of Institutional Funds Act, Part 7 (commencing with Section 18500) of Division 9 of the Probate Code, if that act would otherwise be applicable, but nothing in the Uniform Management of Institutional Funds Act alters the status of governing boards, or the duties and liabilities of directors, under this part.").

[22] Johnson v. Johnson, 515 A.2d 255, 264, 212 N.J. Super. 368, 385-86 (1986) (New Jersey's UMIFA is somewhat different than California's, although the court's amalgam of the two standards resembles the standard in California).

[23] *Id*. at 269 n.19, 212 N.J. Super. at 395 n.19.

[24] *Id*. at 269, 212 N.J. Super. at 396.

decisions. Although the cases do not specifically interpret California's UMIFA, the governing standard of care in each case is similar to that of California's UMIFA.[25] In Maryland, the state's highest court held that divestment from certain holdings in accordance with social considerations is prudent if the costs are minimal, diversification is maintained, divestment occurs gradually, and the investment portfolio is periodically reviewed.[26]

In 1986, the City of Baltimore passed a law barring investments in South Africa and Namibia so long as it was fiscally prudent. A pension board brought suit claiming that the ordinance would cause the board to violate its duty to the beneficiaries. In *Board of Trustees v. Baltimore*,[27] the court interpreted the legality of the Baltimore divestment ordinances. The ordinances were challenged by the trustees of the employee pension systems under several theories, including that the ordinance would alter the duties of prudence and loyalty. For both duties, the court laid out the respective legal definitions. Both of these definitions are based on language from the federal Employee Retirement Income Security Act (ERISA),[28] and are almost identical to the language of California Constitution article XVI, section 17. In holding that the ordinances did not alter the trustees' duty of prudence, the court considered 1) that despite the fact that the ordinances would involve a large proportion of the current holdings[29] the trustees would be able, "to construct an almost perfectly diversified portfolio"; 2) that the transition would occur gradually over a two-year period; and 3) that the ordinances empowered the trustees to suspend divestiture if it became imprudent.[30]

The *Baltimore* court devoted a separate discussion to the issue of whether the ordinances would lead to a breach of the duty of prudence based on the mandate in the ordinances that social factors be considered which were unrelated to investment performance. In upholding the ordinances on this issue, the court held that a trustee's duty of prudence is not violated where "the cost of investing in accordance with social considerations is de minimis . . . ."[31] Applying this standard to the facts, the court found

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[25] Probate Code Section 18506(a) and Corporations Code Section 5231(a) are similar to each other and are both similar to the legal standard governing government pension funds and trusts. *See* CAL. PROB. CODE § 18506 Law Revision Comm'n Comment (1990 Addition) ("The standard of care in subdivision (a) is consistent with the general standard of care provided by Section 16040."). See the *Divestment Action Guide* for a discussion of the legal duties of pension funds in pursuing tobacco divestment, available from the Technical Assistance Legal Ctr. ((510) 444-8252), or the Council for Responsible Public Investment ((510) 208-0400).

[26] *See* Board of Trustees v. Baltimore, 317 Md. 72 (1989).

[27] *Id.*

[28] 29 U.S.C. §§ 1104(a)(1) (West 2000).

[29] Plaintiffs asserted that one-half of the total value of the Standard Poor's 500 would be affected. 317 Md. at 103.

[30] 317 Md. at 103-05.

[31] *Id.* at 108.

that the initial cost of one-sixteenth of one percent of the funds' total value, and the annual cost of one-tenth of one percent of the funds' total value was within the *de minimis* standard announced by the court.

Similarly, with regard to the duty of loyalty, the court held that no violation arises where a trustee considers social consequences of investment decisions if the costs are *de minimis*.[32] The court reasoned that where a trustee invests in businesses with a proper sense of social obligation, that decision may be most effective in securing future benefits, thus fulfilling his duty of loyalty ('solely in the interest of the members' and for the 'exclusive purpose of providing benefits').[33]

While not controlling authority in California, *Baltimore* supports a governing board's decision to avoid tobacco stock based on the threshold the court sets for a plaintiff seeking to challenge the board's decision to sell its tobacco holdings. Such a plaintiff would be hard pressed to show a breach of the duty of loyalty or duty of prudence. With regard to the duty of loyalty, tobacco divestment does not involve self-dealing. With regard to the duty of prudence, a plaintiff claiming to be harmed by a decision to avoid tobacco stock would have to demonstrate 1) that a board did not make an informed decision to avoid tobacco stock, or that the board's decision to divest was wrong on financial grounds; and 2) that the plaintiff has been harmed by the decision. The long-term financial outlook of tobacco stock continues to be uncertain due to potential further regulatory legislation, ongoing litigation, and the volatility of tobacco stock. With a $145 billion jury award pending for punitive damages against the tobacco industry, litigation is continuing. It is therefore unlikely that a plaintiff would convince the trier of fact that, at the time that a governing board chose to exclude tobacco stock from the index fund, tobacco stock was such a promising investment that it clearly was expected to generate a greater return with the same level of risk than substituted investments.

In addition, the scope of divestment in the Baltimore case was much broader than tobacco divestment. Plaintiffs asserted that one-half of the money invested in the Standard & Poor's 500 would be affected.[34] To the extent that California educational foundations and endowments hold tobacco stock, these holdings typically represent a very small portion of their total portfolios. Therefore, these institutions could reasonably conclude that selling any tobacco stock held would have a negligible impact on the total portfolio, especially considering tobacco stock volatility and the uncertainty caused by litigation against the tobacco industry.

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[32] *Id.* at 109-110.

[33] *Id.* at 110.

[34] *Id.* at 103.

The *Baltimore* decision was cited with approval by the Florida Attorney General's Opinion dealing with tobacco divestment.[35] The attorney general was asked to render an opinion on the State Board's then-pending decision on whether to sell the tobacco stock held by the Florida Retirement System Trust Fund. Attorney General Robert Butterworth applied a standard similar to UMIFA's and concluded that a board, after considering the volatility of the stock price, the litigation pending against the tobacco companies, and the then likelihood of U.S. Food & Drug Administration regulation of cigarettes, could decide to divest and fulfill its fiduciary duty.[36] Florida's retirement board also commissioned an outside legal opinion which concluded that a fiduciary may divest where prudence requirements are met.[37] The State Board voted to sell its tobacco stock holdings.

Besides the *Baltimore* court, few courts have ruled on divestment and the duty of prudence. An Oregon court and a Michigan court both ruled on South Africa divestment by the state's public universities. Although the ultimate outcome of both cases was to stymie the respective divestment advocates, the respective appellate courts did so without reaching the ultimate issue of whether divestment can be done without breaching the duty of prudence. In other words, the court halted the divestment efforts for reasons completely separate from the question of whether the divestment efforts were prudent.

In Oregon, the State Board of Higher Education (Board)(a body similar to University of California's Board of Regents) instructed the Oregon Investment Council (OIC) to divest from South Africa.[38] According to the subsequent appellate court opinion,[39] the state trial court ruled that the order to divest violated the prudent investor rule. Although available South Africa-free investment portfolios had demonstrated financially adequate performances, the trial court determined that they had not been in existence for a sufficient length of time to determine whether they provided an adequate rate of return over the long-term.[40] The appellate court's opinion did not reach the merits

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[35] 97 Op. Att'y Gen. 29 (Fla. 1997), WL 348030, at *3.

[36] *Id*., WL 348030 at *5-6.

[37] "[I]f as a part of an investment professional's analysis, he concludes that the risk of holding a security in the plan's portfolio is too high because of anticipated major litigation which could potentially lead to large judgments against the company, the professional may prudently conclude that the sale of the security is best for the portfolio." Memorandum from Ian D. Lanoff regarding Investment and Divestment of Retirement Plan Assets under Applicable Fiduciary Laws to Florida's State Board of Administration (August 29, 1996), at 10 (on file with the Technical Assistance Legal Ctr., 510.444.8252).

[38] Currently (and perhaps during the period in question), OIC is responsible for investing all State of Oregon funds, including the Oregon PERS fund and university endowments.

[39] Associated Students of Univ. of Or. v. Or. Inv. Council, 82 Or. App. 145, 728 P.2d 30 (1986).

[40] *See* Ann-Catherine Blank, Comment, *The South African Divestment Debate: Factoring "Political Risk" into the Prudent Investor Rule*, 55 U. Cin. L. Rev. 201, 208-09, fn. 38 (1986) citing Associated Students of Univ. of Or. v. Or. Inv. Council, No. 78-7502 (Lane County Cir. Ct., 1984).

because it held that the plaintiff (university students) lacked standing to challenge the Board's decision. Moreover, the trial court's 1985 opinion that South Africa-free portfolios had not weathered the test of time does not hold true for tobacco-free portfolios that avoid tobacco investments since a comparison of tobacco investments relative to the stock market as a whole reveals that the stock market has performed equally well or even outperformed tobacco stocks.[41]

In Michigan, the state legislature passed a law directing public universities to divest from South Africa and the Soviet Union. The state appellate court ruled that the legislature did not have the authority to direct the investments of the University of Michigan based on the state constitutional provision that allows only the university to dictate how its endowment funds are invested.[42] The court left unanswered the question of whether the university itself could decide to divest its endowments and other university-controlled portfolios of stock held by companies doing business in South Africa. The University of Michigan's Board of Regents divested from tobacco stock in June, 2000.

Both the Oregon and Michigan cases left open the ability of board members to independently decide to implement divestment. Based on the *Baltimore* decision and UMIFA's prudence standard, a governing board of a California educational foundation or endowment could implement tobacco divestment so long as the decision was financially sound when made and was not expected to reduce the risk-adjusted return of the portfolio. Divestment is also supported by case law, discussed below, that has upheld board investment decisions that were investment neutral but that sought some ancillary benefit.

6. Investments Upheld that Seek to Achieve Non-Financial Outcomes

Tobacco divestment is seeking to achieve an outcome (e.g., avoiding hypocrisy, increasing awareness of tobacco industry perfidy) that is in addition to the financial outcome of investing foundation and endowment assets. Other types of investments likewise seek to achieve outcomes in addition to maximizing risk-adjusted return. Several courts have approved the use of pension fund assets to further some objective that is separate from investment return. The courts have generally upheld these efforts so long as the efforts do not jeopardize the risk-adjusted return of the portfolio.

In *Brock v. Walton*,[43] the court held that a pension fund can lend money to employees covered by that fund for the purchase of residential property, and charge an

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[41] In early 2000, the California State Teachers' Retirement System contracted with BARRA RogersCasey to perform a study of tobacco investments relative to the S&P 500. The study found that in the 13-year period from 1/1/87 to 12/13/99 the S&P 500 outperformed its tobacco index. BARRA RogersCasey, CALSTRS TOBACCO DIVESTITURE STUDY (2000) (on file with Council for Responsible Public Investment, 510.208.0400).

[42] Regents of Univ. of Mich. v. Michigan, 166 Mich. App. 314, 419 N.W.2d 773 (1988).

[43] 794 F.2d 586 (11th Cir. 1986).

interest rate two and one-eighth percentage points lower than the prevailing rates in the community. The court made this holding based on an interpretation of the duty of prudence that applies to pension funds of private companies, which is similar to UMIFA's duty of prudence.[44] The fact that the below-market mortgage loans were offered only to pension beneficiaries suggests that non-financial considerations played a part in offering the loans. This non-financial consideration is not discussed in the *Brock* court's analysis of the board's duty of prudence, suggesting that so long as the board fulfills the duty with regard to its financial obligations, it is free to make loans that offer benefits other than providing for the retirement of the plan beneficiaries. Just as below-market mortgages benefit home buyers, advocates for tobacco divestment believe that selling tobacco stock will contribute to the effort to reduce smoking rates in California.

In another case involving below-market-rate home mortgage loans, *Barrington Police Pension Fund v. Department of Insurance*,[45] an Illinois appellate court held that the fact that the loan program earned a return less than the market rate was "insufficient reason to hold as a matter of law that the program was an imprudent investment in violation of the Pension Board's fiduciary duty."[46] So long as the board of an educational foundation or endowment engages in the necessary financial analysis to ensure that the beneficiaries will not be harmed by pursuing tobacco divestment, *Brock* and *Barrington* provide persuasive legal backing for taking this action.

7. Case Law Involving Board Action Breaching Fiduciary Duty

The *Baltimore*, *Brock* and *Barrington* cases provide guidance in terms of how investment decisions can be influenced by non-financial considerations. Board members can also look for guidance from the cases where the duty of prudence was breached. Cases where a breach of the duty of prudence was found tend to involve gross errors in failing to invest prudently. In *Blankenship v. Boyle*,[47] the trustees of a coal miners' union pension plan placed pension trust money in a bank owned by the union. The bank account earned no interest. The fund also invested in the stock of utility

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[44] *Id*. at 588. Factors that weighed in favor of upholding the mortgage lending rates included 1) the fact that the trustees consulted professionals including lawyers, accountants, actuaries, and mortgage bankers, 2) the trustees determined that they would not find any willing borrowers at the prevailing rates charged by commercial banks, 3) each borrower's employment background, 4) the borrower would pledge accrued pension benefits, 5) the interest rates were at a higher rate of return than any of the other assets in the other 90% of the fund's portfolio, and 6) the interest rates were in excess of the fund's actuarial and funding requirements. *Cf. Donovan v. Mazzola*, 716 F.2d 1226, 1232-33 (9th Cir. 1983) (Court found breach of duty of prudence where union's pension fund made a below market loan to the same union's convalescent fund. Unlike in *Brock*, the circumstances surrounding the loan demonstrated that it did not satisfy the duty of prudence. Before granting the loan, the lending pension fund 1) failed to ascertain the value of the property deeded as security for the loan, 2) failed to discover the unreasonable risk of the loan, 3) the trustees acted on both sides of the transaction, and 4) the loan was at the expense of the lending pension fund.)

[45] 211 Ill. App. 3d 698, 570 N.E.2d 622 (1991).

[46] *Id*. at 707, 570 N.E.2d at 627.

[47] 329 F. Supp. 1089 (D.D.C. 1971).

companies to persuade those utilities to buy union-mined coal. The court held that the pension assets were managed in a way that may have benefitted the union, but was a breach of the duty of prudence since the result was a predictable loss of investment opportunity. It was also a breach of the duty of loyalty since the union, not the beneficiaries, benefitted by the transaction. In *Lynch v. Redfield Foundation* the court found a breach of the duty of prudence where trust income was allowed to accumulate in a non-interest-bearing account for five years.[48] In *Mandel v. Cemetary Board*, the trustees breached the duty of prudence where 80 percent of cemetery endowment was lent to a limited partnership.[49] And in *Collins' Estate*, the court found a breach where the trustees invested two-thirds of a trust principal in junior mortgage in single piece of property.[50]

A plaintiff who decides to challenge the legality of a board's decision to avoid tobacco stock would have a hard time persuading a court that a board's action is similar to the above cases. A divestment decision does not breach the trustees' duties since it has none of the hallmarks of imprudent decision-making.

Conclusion

A governing board of a university endowment or foundation can choose to divest from tobacco stock so long as the assets are reinvested in investments of similar risk and projected return. The trustees can decide that tobacco stocks are a bad investment, and that selling the current holdings and avoiding these investments in the future is warranted on purely financial grounds. Alternatively, if the board finds that non-tobacco investments offer equivalent risk-adjusted return, and all other things are equal, the board can sell tobacco stocks based on non-financial reasons.

[48] 9 Cal. App. 3d 293 (1970).

[49] 185 Cal. App. 2d 583 (1960).

[50] 185 Cal. App. 2d 583 (1960).