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Beyond Grantmaking: Additional Mechanisms for Mission

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I. INTRODUCTION

According to statistics compiled from the National Center for Charitable Statistics, there are more than 86,000 foundations in the United States with more than 78,000 being classified as independent foundations (i.e. private non-operating foundations that are not corporate foundations).[1] Private non-operating foundations generally do not directly perform charitable programs or services, but rather pursue their charitable purposes through their grant-making activities. In 2013, foundations gave nearly $55 billion for charitable purposes (approximately $37 billion came from independent foundations).[2] In the aggregate, grant-making private foundations make hundreds of thousands of grants annually, funding many diverse areas from education and health to arts, the environment, public affairs, religion, and scientific research. However, these broad categories, while garnering the most grant dollars, do not constitute an exclusive list. Rather, grant-making foundations may make grants for any purpose considered exempt under Section 501(c)(3) so long as certain rules of the road are obeyed.

While making an enormous impact through their grant dollars, grant-making foundations have a rich history of going beyond their grant-making programs. There is a subset of private foundations and philanthropists who desire more involvement. They want to leverage their expertise, to supplement their grant-making dollars, and to invest strategically and programmatically. At the same time, these foundations continue to be subject to the prohibited transaction rules set out in the Internal Revenue Code (the "Code"). How will program expenses for charitable activities be treated under the minimum distribution requirement rules of Section 4942? Will a strategic investment into a low-income area of the community at less than fair market rates without security be a jeopardizing investment under Section 4943 of the Code? Is there a better way to structure a foundation who decides to change focus and conduct only charitable activities? Should a foundation create a new entity to put a liability shield between its charitable activities other than passive grant making and its endowment? These questions, and others, will be considered in this paper.

II. PRIVATE FOUNDATIONS IN CONTEXT

The word "foundation" can be deceptive, as it may refer to any number of nonprofit organization types. The Code defines a private foundation as any domestic or foreign organization described in I.R.C. § 501(c)(3) that does not qualify under one of the specifically-enumerated categories of public charities set out in § of the Code. Private foundations, as a result of a perceived lack of public oversight and accountability, are subject to a series of provisions in the Code describing excise taxes that, with the exception of the net investment income excise tax, are imposed for certain actions of the foundation.

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[1] *See* The Foundation Center, *Key Facts on U.S. Foundations*, 2014 (visited Nov. 29, 2016) <foundationcenter.org/gainknowledge/research/keyfacts2014/>.
[2] *See id.* (citing *Giving USA Foundation*, Giving USA, 2013).

A. EXCISE TAX ON INVESTMENT INCOME (I.R.C. § 4940)

A private foundation is subject to an excise tax of 2% of its net investment income and, unlike the excise taxes listed below, this tax is unavoidable. The excise tax may be reduced from 2% to 1% provided that the foundation meets a "maintenance of effort" test.[3] The net investment income equals gross income (interest, dividends, rents, royalties and realized capital gains), minus all ordinary and necessary expenses paid or incurred for the production or collection of such income. It includes the gain on the sale of appreciated property because the foundation receives a carry-over basis from the donor. However, if the assets are gifted upon the death of a donor, the assets receive a step-up in basis as to the date of the donor's death. The ordinary and necessary expenses paid or incurred for the production and collection of such income and which are not subject to the excise tax include: brokerage fees, investment management fees and director fees applicable to managing the investments. Failure to pay the excise tax in a timely fashion subjects the foundation to penalties and interest applicable to other corporate filers.

B. MINIMUM DISTRIBUTION REQUIREMENTS (I.R.C. § 4942)

A private foundation must generally distribute approximately 5% of its assets on an annual basis in qualifying distributions. These assets are those not used in furtherance of the exempt purposes of the foundation (e.g., the distribution requirement is based on the foundation's investment assets). This minimum distribution is required to prevent foundations from holding gifts, investing the assets and never spending the assets on charitable purposes. A foundation has until the end of the next tax year to satisfy the minimum payout requirement for that taxable year. Generally, a private foundation's qualifying distributions will consist of grants to qualified charitable organizations (§ 501(c)(3) public charities). (Private foundations may no longer count grants or payments to supporting organizations classified as non-functionally integrated Type III supporting organizations or that are directly or indirectly controlled by persons who are disqualified persons of the foundation as part of their qualifying distributions.) Qualifying distributions also include grants to non-charities for "charitable purposes," costs of all direct charitable activities (such as running a library or art gallery, providing technical assistance to grantees, maintaining a historical site, conducting a conference, etc.), amounts paid to acquire assets used directly in carrying out charitable purposes, set asides, program-related investments and all reasonable administrative expenses necessary for the conduct of the charitable activities of the foundation.

C. EXCESS BUSINESS HOLDINGS (I.R.C. §4943)

To prevent private foundations from having an advantage over other businesses which operate in the taxable income sector, Congress and the Internal Revenue Service have adopted restrictions on a private foundation's ability to engage in certain business activities. A private foundation may own up to 20% of the voting power in a business enterprise, reduced by the percentage of voting stock held by all disqualified persons. If control of the entity can be shown to be held by

[3] The foundation must demonstrate that its qualifying distributions paid out before the end of the tax year equal or exceed the sum of (a) the 5-year average payout times current years assets, plus (b) 1% of net investment income. If this test is met, the applicable tax is reduced to 1%.

non-disqualified persons, the foundation and the disqualified persons may own up to 35% of the entity's voting interest. The foundation may hold a non-voting interest, but only if all disqualified persons together hold no more than 20% of the voting interest or no more than 35% of the voting interest if effective control is with a non-disqualified person(s). The foundation may own up to a de minimis 2% of the voting stock or value without having to consider amounts owned by disqualified persons for the purpose of excess business holdings.

D. JEOPARDIZING INVESTMENTS (IRC § 4944)

A private foundation must not make investments which would jeopardize the carrying out of its exempt purposes. Although no investment is a per se violation, this rule requires close scrutiny of foundation managers' standard of care. The foundation managers will be held to a "prudent investor" standard of care. Caution should be exercised in the consideration of speculative investments such as working interests in oil and gas, trading on margin, trading in commodity futures, purchase of "puts" and "calls" and "straddles", warrants, selling short or other high risk investments. This restriction applies to investment actions by the foundation managers and does not apply to assets received by a private foundation by gift or bequest.

E. TAXABLE EXPENDITURES (IRC § 4945)

A private foundation is prohibited from making expenditures not in furtherance of the foundation's exempt purposes. Taxable expenditures include amounts paid or incurred by a private foundation to carry on propaganda or otherwise attempt to influence legislation or the outcome of any public election. Additionally, if the foundation makes a distribution to another private foundation, a non-functionally integrated Type III supporting organization, an entity exempt under a section of the Code other than § 501(c)(3), or a taxable entity, it must monitor (i.e., exercise expenditure responsibility) the grant in order to avoid a penalty. Exercise of expenditure responsibility includes the conducting of a pre-grant inquiry concerning grantee's management and programs, obtaining a written agreement from the grantee prior to making the grant, obtaining regular written status reports from the grantee regarding its progress in using the grant, and filing reports regarding the grant's status with the private foundation's annual information return and checking the appropriate box.

III. BRIEF OVERVIEW OF FIDUCIARY DUTIES

While the power to act for the organization is typically vested in a Board of Directors acting collectively, each director owes certain fiduciary duties to the organization. Fiduciary law developed as common law with various aspects subsequently codified in state trust and corporate statutes. Directors of corporations owe a strict fiduciary obligation to the corporation as a matter of law. In the charitable context, directors owe fiduciary duties to the corporation they serve and to the public in charity. Charitable fiduciaries stand in the unique position of being the keeper of the organization's assets and the guardian of the organization's mission. This unique role plays itself out in the duties of care, loyalty, and obedience. Decision makers exercise these duties largely in the realm of making strategic decisions, evaluating, reviewing, overseeing, and approving of actions. Because directors must always be concerned with satisfying their fiduciary duties when making decisions on behalf of the foundation, it is useful to review these duties prior to turning to considering what additional mechanisms for mission are available.

A. DUTY OF CARE

Nonprofit managers are subject to the fiduciary duty of care. The duty of care, most simplified, is a duty to stay informed and exercise ordinary care and prudence in management of the organization. With respect to nonprofit directors, the duty of care generally obligates the decision maker to act (1) in good faith, (2) with ordinary care, and (3) in a manner he or she reasonably believes to be in the best interest of the corporation.[4]

1. Good faith

The law rarely seeks to define "good faith" in the context of fiduciaries. Broadly, the term describes "that state of mind denoting honesty of purpose, freedom from intention to defraud, and, generally speaking, means being faithful to one's duty or obligation."[5] In claims for legal malpractice, for example, "good faith" is a defense wherein the attorney can demonstrate that he made a decision that a reasonably prudent attorney could have made in the same or similar circumstances.[6] Thus, at least in the context of legal malpractice (which bears many similarities to breach of fiduciary duty), good faith is measured objectively based on objective facts. "Good faith" can, however, be contrasted with "bad faith." One court has stated that a fiduciary acts in bad faith when the fiduciary acts out of a motive of self-gain.[7] Certainly bad faith would also include intent to affirmatively do harm to the organization. As a result, good faith would include putting the good of the organization first and seeking to affirmatively benefit the organization.

2. Ordinary care

"Ordinary care" requires the director to exercise the degree of care that a person of ordinary prudence would exercise in the same or similar circumstances. It should be noted that where the director has a special expertise (e.g., accounting expertise, legal expertise, etc.), ordinary care means that degree of care that a person with such expertise would exercise in the same or similar circumstances. A director may delegate decisions (including investment decisions) if she exercises reasonable care, skill, and caution in selecting the agent, establishing the agent's scope, and periodically reviewing the agent's actions to confirm conformance with the terms of the delegation. For example, it is common for the directors of a family foundation to delegate administrative matters to employees of a family office. While a director may delegate these types of decisions or activities, she cannot delegate her oversight (i.e. governance) responsibility.

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[4] *See, e.g.,* Tex. Bus. Orgs. Code § 22.221(a).
[5] *See* BLACK'S LAW DICTIONARY 693 (6th ed. 1990).
[6] *See Cosgrove v. Grimes*, 774 S.W.2d 662, 665 (Tex. 1989).
[7] *See Bohatch v. Butler & Binion*, 905 S.W.2d 597, 602 (Tex. App.—Houston [14th Dist.] 1995) *aff'd* 977 S.W.2d 543 (Tex. 1998).

To satisfy her duty to use ordinary care, the director should be reasonably informed with respect to the decisions she is required to make. Specifically, the decision maker must understand the purposes of the organization as set forth in the organization's governing documents and make decisions comporting with those purposes and direction. Furthermore, the decision maker should be familiar with management of the organization, policies of the organization, and any financial data relevant to the decisions she is making. Such familiarity and knowledge requires that the director attend board meetings and actively seek the information necessary to make an informed and independent decision regarding which course of action is in the corporation's best interest. A director should be careful to personally weigh the benefits and detriments of the course of action to the corporation rather than simply voting with the majority.

In discharging the duty of care, it is common for state law to provide that a director may rely in good faith on information, opinions, reports, or statements, including financial statements or other financial data, concerning the corporation or another person that was prepared or presented by officers, employees, a committee of the board of which the director is not a member, or, in the case of religious corporations, (1) a religious authority; or (2) a minister, priest, rabbi, or other person whose position or duties in the corporation the director believes justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented.[8] While a director may rely on the counsel of advisers, the director must nevertheless exercise her own independent judgment in making decisions as to what is in the corporation's best interests. Professionals serving as decision makers, such as attorneys and CPAs, should note that the ability to rely in good faith on others as referenced above will generally not apply where the professional/decision maker is the source of the information, opinion, report, or statement.

3. Best interest of the corporation

Finally, decision makers must make decisions they reasonably believe to be in the best interest of the organization. Reasonableness is based on the objective facts available to the decision maker—not simply what the individual knows but what she should have known as well. Determining whether a proposed action is in the best interest of the corporation requires weighing of many factors, including the short-term interests, the long-term interests, the costs, the benefits, etc.

Decision makers of nonprofit corporations generally have the protection of the business judgment rule so long as those persons exercise their best judgment in making decisions on behalf of the organization. The business judgment rule rests on the concept that to allow a corporation to function effectively, "those having managerial responsibility must have the freedom to make in good faith the many necessary decisions quickly and finally without the impairment of facing liability for an honest error in judgment."[9] It is reasoned that the rule only applies by default to nonprofit corporations because trusts are generally not operating entities in the sense of carrying on their own programs and thus the concept does not have the same

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[8] *See, e.g.,* Tex. Bus. Orgs. Code § 3.102; Tex. Bus. Orgs. Code § 22.222.

[9] *See* MARILYN E. PHELAN & ROBERT J. DESIDERIO, NONPROFIT ORGANIZATIONS LAW AND POLICY 109 (2003) (citing *Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973).

relevance.[10] Of course trusts may, in fact, carry on their own programs, and in such circumstances the trust document may provide similar levels of protection for trustees.

B. DUTY OF LOYALTY

The second significant fiduciary duty owed by decision makers of nonprofit organizations is the duty of loyalty. The duty of loyalty requires that the decision maker act for the benefit of the organization and not for her personal benefit, i.e. the duty of loyalty requires undivided loyalty to the organization.

Under Texas law, which is consistent with the majority view, the duty of loyalty mandates that a trustee administer the trust property solely for the benefit of the beneficiaries, avoiding any transaction that would benefit the trustee to the detriment of the beneficiaries. To ensure compliance with this strict duty of loyalty, the law prohibits conflict of interest transactions even where such transactions are fair to the beneficiaries unless the trustee made full disclosure of the transaction and obtained the consent of the beneficiaries.[11] The trustee bears the burden to demonstrate full disclosure and consent. If the trustee is unable to satisfy this burden, the transaction may be set aside, regardless of its fairness to the beneficiaries. It should be noted that a loan of trust funds to the trustee or a purchase or sale by the trustee of trust property from or to (i) the trustee or an affiliate; (ii) a director, officer, or employee of the trustee or an affiliate; (iii) a relative of the trustee; or (iv) the trustee's employer, partner, or other business associate may be set aside irrespective of disclosure.[12]

As with the duty of care, corporate decision makers are subject to a less exacting statutory application of the duty of loyalty in comparison to a trustee. Again, the trust document can be expanded to make these rules consistent. To satisfy her duty of loyalty, a corporate decision maker must look to the best interest of the organization rather than private gain. As the Texas Supreme Court has stated, the duty of loyalty requires an "extreme measure of candor, unselfishness, and good faith."[13] The director must not usurp corporate opportunities for personal gain, must avoid engaging in interested transactions without board approval, and must maintain the organization's confidential information. The prohibition against self-dealing under § 4941 of the Code overlays the duty of loyalty and, as a result of its automatic excise tax, often takes prominence.

C. DUTY OF OBEDIENCE

A third duty is often added – the duty of obedience.[14] The duty of obedience is the duty to remain faithful to and pursue the goals of the organization and avoid *ultra vires* acts. In practice, the duty of obedience requires the decision maker to follow the governing documents of

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[10] *See, e.g., Stern v. Lucy Webb Hayes Nat'l School for Deaconesses and Missionaries*, 381 F. Supp. 1003, 1013 (D. D.C. 1974).
[11] *See, e.g.,* TEX. TRUST CODE §§ 113.060; 117.007.
[12] *See, e.g.,* TEX. TRUST CODE §§ 113.052; 113.053.
[13] *See International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963).
[14] *See, e.g.*, Johnny Rex Buckles, *How Deep are the Springs of Obedience Norms that Bind the Overseers of Charities?*, 62 Cath. U. L. Rev. 913 (2013).

the organization, laws applicable to the organization (including reporting and regulatory requirements), and restrictions imposed by donors. The duty of obedience thus requires that decision makers see that the corporation's purposes are adhered to and that charitable assets are not diverted to non-charitable uses. There continues to be scholarly debate regarding the duty of obedience and whether it should be separately identified as a distinct fiduciary duty. The American Law Institute's Principles of Law of Nonprofit Organizations decline to separately identify the duty of obedience.[15] However, those Principles recognized the concepts widely understood to be concepts of obedience (e.g., following the law, fidelity to the purposes of the corporation, following gift restrictions) as applicable components of the duties of care and loyalty. Although case law is limited with respect to specific discussion of the duty of obedience, decision makers are well-advised to understand and appreciate the duty of obedience if for no other reason than because the charity regulators, charged with enforcing nonprofit director compliance with fiduciary norms, often recognize the duty.[16]

The duty of obedience is somewhat unique to the nonprofit context and particularly tax-exempt organizations. Because tax exemption rests in the first part on being organized for an appropriate tax-exempt purpose (be it charitable or social), these organizations more specifically identify their purposes in their governing documents compared to a for profit business which may be organized to conduct all lawful operations of whatever kind or nature. One court has noted the distinction stating that "[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the raison d'etre of the organization."[17] With the additional level of specificity as to purpose, the decision maker faces a more defined realm of permissible actions. That realm can be even more narrowly defined when funds are raised for specific purposes.

Because the duty of obedience requires pursuit of the mission of the organization and protection of charitable assets, it is clearly important to understand the purposes of the organization. In the context of a nonprofit corporation, the purpose is stated in the organization's governing documents and may be amplified by other documents such as testamentary documents directing the creation of the organization, the application for exempt status filed with the Internal Revenue Service or solicitations for contributions. Each of these sources should be consulted, though the basic statement of purpose in the Articles of Incorporation/Certificate of Formation/Declaration of Trust should be given primacy.

IV. DIRECT CHARITABLE ACTIVITIES

A. MINIMUM DISTRIBUTION REQUIREMENT AND QUALIFYING DISTRIBUTIONS

Pursuant to Section 4942 of the Code, a private non-operating foundation must generally distribute at least 5% of the aggregate fair market value of its assets on an annual basis in

[15] *See Principles of the Law of Nonprofit Organizations*, § 300, cmt. (g)(3) (American Law Institute).
[16] *See, e.g.*, John W. Vinson, *The Charity Oversight Authority of the Texas Attorney General*, 35 St. Mary's L. J. 243, 272-73 (2004).
[17] *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 595 (Sup. Ct. 1999).

qualifying distributions.[18] These assets are its investment assets (i.e. those not used in furtherance of the exempt purposes of the foundation, such as the building in which the foundation offices and where its capital equipment and fixtures are located), generally including cash, stocks, bonds, and other investment assets.[19] This minimum distribution is required to prevent foundations from holding gifts, investing the assets and never spending the assets on charitable purposes.

If a private foundation fails to meet its required payout in qualifying distributions by the close of the following taxable year, the foundation is assessed a penalty of 30% of the difference between the amount actually distributed and the amount which should have been distributed.[20] An additional penalty of 100% of the undistributed amount is assessed if the original penalty is assessed and the distribution is not timely made.[21] These penalties can repeat each year thereafter if the required distributions are not made.[22] The penalties apply only to the foundation and not to any foundation manager.[23]

While many foundations think only in terms of grants to public charities as qualifying distributions, the rules are actually much broader. Qualifying distributions also include grants to non-charities for "charitable purposes" (subject to certain restrictions that will be discussed in this paper), costs of all direct charitable activities, amounts paid to acquire assets used directly in carrying out charitable purposes, certain set-asides, reasonable administrative expenses necessary for the conduct of the charitable activities of the foundation, and certain investments referred to as program-related investments.[24]

B. WHO IS ENGAGING IN DIRECT CHARITABLE ACTIVITIES?

In addition to the making of program-related investments, a second method of going beyond a standard grant-making program is conducting direct charitable activities. The ability of private non-operating foundations to conduct direct charitable activities (essentially operate a charitable program in a non-operating entity) has been recognized since the Treasury Regulations implementing the private foundation tax regime were first put in place in 1969.[25] Those regulations recognized direct charitable activities ranging from technical assistance for grantees to ensure sustainability and greater impact, to complete research programs seeking to inform public policy.

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[18] IRC § 4942; Reg. § 53.4942(a)-3(a)(2).
[19] Reg. § 53.4942(a)-2(c).
[20] IRC § 4942(a)(1).
[21] IRC § 4942(b).
[22] IRC §§ 4942(a) and (b).
[23] IRC § 4942.
[24] Reg. § 53.4942(a)-2(c)(3).
[25] IRC § 4942(g)(1)(B); *see also* Foundation Center, *More than Grantmaking: A First Look at Foundations' Direct Charitable Activities*, 2007 (visited Nov. 29, 2016) <foundationcenter.issuelab.org/resource/more_than_grantmaking_a_first_look_at_foundations_direct_charitable_activities>.

While spending for direct charitable activities has always been available to private non-operating foundations, the 990-PF has never provided a succinct methodology for reporting direct charitable activities.[26] As a result, the size and extent of a foundation's direct charitable activities cannot truly be ascertained. In 2007, the Foundation Center, a leading authority on philanthropy in existence since 1956, conducted a survey to take a closer look at the direct charitable activities of private foundations.[27] The Foundation Center survey was subsequently summarized in a report (the "Foundation Center Report"), offering a more detailed examination of more than 900 foundations ranked among the top 3,000 foundations in terms of total giving in 2005.[28] Key findings included that a full 25% of those foundations surveyed reported that they do conduct direct charitable activities, with larger foundations (those making grants of $10 million or more annually) more likely to conduct direct charitable activities (a full 50% of these foundations reported conducting direct charitable activities).[29] Notably, community foundations have significantly higher levels of participation in direct charitable activities (61%) compared to independent foundations (25%) or corporate foundations (16%).[30] While the surveyed foundations reported a number of direct charitable activities, the Foundation Center Report summarized the various activities into three primary types: (1) convening conferences; (2) providing technical assistance to grantees; and (3) supporting staff service on advisory boards of other charities.[31] The common thread among these three primary types of activities is the desire to strengthen the effectiveness of philanthropy through collaboration and capacity building.[32] This is understandable giving the numbers above related to the participation of community foundations, which traditionally have a significant role in capacity building and seeking to build effectiveness in the philanthropic community.

C. WHAT CONSTITUTES A DIRECT CHARITABLE ACTIVITY?

Given the popularity of direct charitable activities and the availability of direct charitable activities to supplement a foundation's grant-making program, it is worthwhile to consider what constitutes a direct charitable activity that will be considered a qualifying distribution.

While there is no comprehensive list in the Code or regulations, the instructions to Form 990-PF include a number of examples. The Foundation Center Report grouped those examples from the 990-PF instructions into the following groups:

(1) Convening educational conferences that are not limited to a foundation's own staff/board;

(2) Providing technical assistance/training to grantees in other charitable organizations;

[26] *See* Foundation Center, *supra*, at 1.
[27] *See id*.
[28] *See id*.
[29] *See id*.
[30] *See id*.
[31] *See id*.
[32] *See id*.

(3) Supporting the service of foundation staff on advisory boards of other charities or public commissions;

(4) Conducting research that goes beyond assessment of potential grants;

(5) Publishing and disseminating reports on research findings, education, conferences, etc., of broad interest to the public;

(6) Maintaining facilities used for direct services; and

(7) Operating direct service programs.[33]

The list above is obviously a non-exhaustive list with significant room for variation from foundation to foundation. For example, the last category listed above (operating direct service programs) could be as broad as any public charity charitable program activity. For example, the author has worked with private non-operating foundations that conduct direct charitable activities, including the creation of a scientific consortium to study a rare neurodegenerative disease with the program involving strategic grant-making coupled with foundation-hosted gatherings for researchers from around the world to present the findings of their research and collaborate together on future work. Other direct charitable activities of this same foundation have included working with consultants, other foundations, and interested parties, along with local school district personnel, to provide "cradle to career" services spanning early childhood education through graduation to improve the lives of at-risk children and, as a result, their local communities. These types of collaborative efforts, where not only funding is provided but also strategic guidance, conferences, and collaborative meetings, are all ways in which a foundation can make qualifying distributions through direct conduct. In each instance, the direct charitable activities complement the grant-making activities of the foundation.

The takeaway from the examples provided is that when a foundation conducts a charitable program using its resources to provide staffing and oversight and direction of the program, it will qualify as a direct charitable activity and be treated as a qualifying distribution.

D. REPORTING DIRECT CHARITABLE ACTIVITIES

To understand the reporting of direct charitable activity expenses, it is necessary to understand that qualifying distributions under Section 4942(g) include any amount paid to accomplish one or more purposes described in Section 170(c)(2)(B) [charitable activities] other than any contribution to (1) a controlled organization or (2) a private foundation which is not an operating foundation unless the out of corpus rules are followed.[34] Accordingly, private foundations may include as qualifying distributions amounts paid as direct or indirect charitable expenditures, including expenditures related to direct charitable activities.[35]

[33] *See id*. at 2-3.
[34] IRC § 4942(g)(1).
[35] Reg. § 53.4942(a)-3(a)(8).

Direct expenses are those that can be specifically identified with a particular charitable activity, including (1) compensation and travel expenses of employees and officers in relation to a particular charitable activity, (2) the cost of materials and supplies related to a particular charitable activity, and (3) fees paid to outside firms and individuals related to a particular charitable activity. Indirect expenses are those that are not specifically identifiable with a particular charitable activity, but are nevertheless costs incurred in conducting the charitable activity, including (1) occupancy expenses; (2) supervisory and clerical compensation; (3) repair, rental, and/or maintenance of equipment; and (4) expenses of other departments (such as accounting, personnel, and payroll that serve the department or function that incurs the direct expenses of conducting an exempt activity). In either case, the expenses, if used for both charitable and investment purposes, must be allocated. Regardless of whether such direct and indirect expenses are incurred as a part of a foundation's grant-making program or program of direct charitable activity, such direct and indirect expenses, so long as they are reasonable and necessary to the exempt purpose, will be considered qualifying distributions.[36]

As referenced above, the 990-PF does not provide an easy methodology for clearly reporting the direct charitable activities of a private foundation. As a result, it is easy for the 990-PF to be misconstrued by those reviewing it (including regulators, the media, watchdog groups, or other interested persons), especially with respect to the ratio of administrative costs to grants, not understanding the nature of administrative costs related to direct charitable activities.[37] This results from the fact that the expenses attributable to direct charitable activities are included in Part I of the 990-PF but are not broken out separately. While Part IX-A calls for a summary of direct charitable activities, many readers of the Form 990-PF will never get that far. A foundation interested in conveying the benefit and scope of its direct charitable activities may want to provide a type-written cross-reference to Part IX-A, indicating that the amount listed as total operating and administrative expenses at Line 24(d) on the bottom of page 1 includes a set dollar amount of charitable programs conducted directly by the foundation and more fully described at Part IX-A.[38] A foundation may also wish to attach a schedule to its 990-PF providing a detailed explanation of the foundation's expenses for the year.[39] Similar to the way public charities describe their mission and programs on Schedule O, a private foundation may wish to provide more expanded detail on its direct charitable activities. Because a foundation does not solicit funds, it may see little benefit in this; however, for the foundation that wants to highlight its activities, such a detailed description is beneficial.

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[36] In addition to the qualifying distributions listed above, other common qualifying distributions are expenses incurred in preparing Form 990-PF, expenses incurred in making Form 990-PF available for public inspection (or making copies), publication of an annual report made available to the public, and even legal fees paid in relation to accomplishment of an exempt purpose.

[37] PriceWaterhouseCoopers LLP, *10 Common Errors to Avoid in Completing a Private Foundation's Form 990-PF*, at 7 (Forum of Regional Associates of Grantmakers 2007).

[38] *See id*. at 8.

[39] *See id*.

V. PROGRAM-RELATED INVESTMENTS

A. LAW RELATED TO PRIS

The term "program-related investment" appears in the Internal Revenue Code at section 4944(c) as an exception to the general prohibition against private foundations investing in such a manner as to jeopardize the carrying out of their exempt purposes. Section 4944(c) provides as follows:

> (c) Exception For Program-Related Investments. – For purposes of this section, investments, the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property, shall not be considered as investments which jeopardize the carrying out of exempt purposes.

TREASURY REGULATION Section 53.4944-3 provides additional specificity as to what constitutes a PRI.

> A "program-related investment" is an investment which possesses the following characteristics:
>
> (i) The primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B);
> (ii) No significant purpose of the investment is the production of income or the appreciation of property; and
> (iii) No purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(B)(2)(D) [political purposes].

As a result of the definitions set forth in the above cited TREASURY REGULATION, PRIs are said to be subject to three tests: (1) the primary purpose test; (2) the no significant investment purpose test; and (3) the no political purpose test.

1. The Primary Purpose Test

Section 53.4944-3(a)(2)(i) provides that an investment is made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) (i.e. charitable or other exempt purposes) if it *significantly furthers* the accomplishment of the private foundation's exempt activities and if the investment would not have been made *but for* the investment's relationship to the foundation's exempt activities.

A determination of whether the investment significantly furthers the accomplishment of the private foundation's exempt activities requires an initial examination of the foundation's own governing documents to determine the scope of the foundation's exempt purposes (i.e. are those purposes broad—"charitable, religious, and educational purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code," or are those purposes more narrow, such as limiting the exempt purposes to medical research). To understand if a specific investment will significantly further an exempt purpose of the foundation, the beginning point must be what are those purposes of the foundation? After determining the purposes of the foundation, the governing board must determine that the proposed investment is consistent with those purposes. If a proposed investment is consistent with general charitable or other exempt purposes under sections 501(c)(3) and 170(c)(2)(B), but is inconsistent with more restrictive purposes in the foundation's own governing documents, the foundation should either pass on the investment or take steps to expand its purposes.

Determining whether the proposed investment is made to further an exempt purpose should be focused on the exempt purpose (such as relief of the poor and distressed or underprivileged) and not on whether or not the organization that is going to carry out that purpose is itself an exempt organization. Specifically, section 53.4944-3(a)(2)(i) provides that "[f]or purposes of section 4944 and §§ 53.4944-1 through 53.4944-6 the term "purposes described in section 170(c)(2)(B)" shall be treated as including purposes described in section 170(c)(2)(B) whether or not carried out by organizations described in section 170(c)." It is this clarification that allows private foundations to make program-related investments to non-exempt organizations. Put simply, it is not the recipient of the funds that is most significant, but rather the use of the funds and how that use of the funds furthers one or more exempt purposes *of the foundation*. Accordingly, each investment must be separately analyzed to determine that the investment does, in fact, significantly further the foundation's charitable purposes, and that but for such relationship between the investment and the accomplishment of the foundation's exempt activities, the investment would not have been made. Foundations may find it useful to have contemporaneous documentation showing the purposes of the investment and how the investment is intended to further the foundation's exempt purposes. This type of documentation strengthens the foundation's position that the investment would not have been made but for its relationship to the foundation's exempt purposes.

2. No Significant Investment Purpose Test

To qualify an investment as a program-related investment, the private foundation must show that no significant purpose of the investment is the production of income or the appreciation of property. Pursuant to the regulations, the IRS will consider it relevant whether investors solely engaged in for profit investment activities would be likely to make the investment on the same terms as the private foundation.[40] Similarly, where a foundation has an investment policy (which prudent foundations should have), analyzing whether such investment policy would allow for the proposed investment with the terms being considered is also a relevant factor in showing that the foundation is making the investment without a significant purpose of producing income or causing the appreciation of property. The regulations point out, however, that the fact that the investment produces income or capital appreciation, even where significant will not, standing alone, be conclusive evidence of a significant purpose involving the production of income or appreciation of property.[41] Rather, the analysis is at the front end of the investment, whether the terms (interest rate, risk level, level of security, etc.) would be attractive

[40] *See* Reg. § 53.4944-3(a)(2)(iii).
[41] *See id*.

to for profit investors and commercial lenders. Because the analysis is done at the front end of the investment, the contemporaneous documentation addressed above regarding the foundation's purposes at the outset can further prove useful in showing that the foundation did not have a significant purpose involving the production of income or the appreciation of property.

The majority of PRIs that are the subject of private letter rulings are made as loans or guarantees. These can be, and are, typically made at below-market interest rates thereby allowing the foundation to demonstrate that the loan is one whose terms would not be attractive to for profit investors or commercial lenders. Again, however, the interest rate is not the only factor to be considered. Loans may be made with inadequate security, to recipients with no credit history or poor credit, or with other terms that cause the loan to carry higher risk. In these cases, the foundation can show that the loan would not be attractive to a for profit investor. Where PRIs take other forms (equity investments, loan guarantees, linked deposits, etc.) the terms of the proposed investment must be closely analyzed to determine whether such terms demonstrate a lack of a for profit motive. There are myriad private letter rulings discussing PRIs and considering this second test. Those rulings are not precedential authority, but do provide a helpful look at other situations that the IRS has found to demonstrate a lack of a production of income/appreciation of property motive. Where the investment terms are not clearly outside of the scope of what a for profit investor would consider, a foundation should review such private letter rulings and consider obtaining a private letter ruling or opinion of counsel letter related to this issue.

While the regulations provide that no significant purpose of the investment is the production of income and appreciation of property, regulations do not prohibit the foundation from making PRIs that produce income or result in the appreciation of property or even making PRIs where the production of income or the appreciation of property is a purpose—it must merely refrain from making such investments where these goals are a *significant* purpose. PRIs are, by definition, not grants. In setting up these types of investments, foundations generally build in interest along with a return of the principal. It is this ability to get a return on investment that makes PRIs an attractive alternative to grants, allowing foundations to recycle their philanthropic dollars over and over again. A foundation is willing to accept terms that would not be acceptable to for profit investors and commercial lenders of the relationship between the investment and the accomplishment of the foundation's exempt purposes. In this way, the foundation is receiving (in the event that there is no default) a monetary return on its investment as well as social return on this same investment.

3. No Political Purpose Test

The final test that must be met for a foundation to demonstrate that an investment qualifies as a program-related investment is a showing that no purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(D), such purposes including attempting to influence legislation and participating in, or intervening in political campaigns on behalf of or in opposition to a candidate for elective public office.[42] This is an

[42] There is a limited exception related to a PRI recipient appearing before or communicating with legislative body with respect to legislation or proposed legislation of direct interest to the recipient where the expense of engaging in

absolute prohibition for PRIs as compared to a private foundation being allowed to seek to influence legislation so long as it does so to an insubstantial degree.

Satisfaction of this test is most often accomplished through the inclusion of commitments on the part of the recipient or representations and warranties on the part of the recipient that the funds will not be used for such purposes. These types of commitments, representations and warranties can easily be included in loan documentation, guarantee documentation, etc. Where the foundation is making an equity investment, the foundation must take care to obtain a representation that the recipient will not engage in such practices or will otherwise segregate the foundation's funds to ensure that such funds are not used to accomplish such prohibited purposes. Such a representation can be handled in a side agreement which can also serve as a useful place to recite and memorialize the foundation's purposes in making the PRI at the outset of the investment, showing from the outset that the purpose is furtherance of the foundation's exempt purposes and not production of income or appreciation of property.

4. Changes in Terms

Terms of investments often change over time. This can be true of program-related investments as well. Because the determination of whether an investment qualifies as a PRI is made at the outset of the investment, care should be given as to whether changes in the terms of the investment will cause the investment to cease to qualify as a PRI. Section 53.4944-3(a)(3)(i) answers this question.[43] That section provides that a PRI does not cease to qualify as such "provided the changes, if any, in the form or terms of the investment are made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property." Where changes are "made in the form or terms of a program-related investment for the prudent protection of the foundation's investment," such changes will not ordinarily cause the investment to no longer qualify as a PRI.[44] Where a change is made other than for the prudent protection of the foundation's investment, the foundation should analyze the need for such change and document that the change is made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property. The foundation may wish to obtain a written legal opinion regarding such issue.

If a change is determined to be a "critical change in circumstances," the investment will cease to be program-related.[45] As an example of a "critical change of circumstances," the regulations point to an investment that is shown to be serving an illegal purpose or the private purpose of the foundation or its managers; however, these are not the only types of "critical changes" and each proposed change must be independently examined. Where the change is considered a "critical change" which causes the investment to cease to be program-related, the foundation and the foundation managers will be subject to the excise tax on jeopardizing investments unless the investment is terminated within thirty (30) days after the date on which

such activities would qualify as a business deduction under section 162 of the Code. However, PRI funds cannot be earmarked for such use.

[43] Reg. § 53.4944-3(a)(3)(i).

[44] *See id*.

[45] *See id*.

the foundation (or any of its managers) obtains actual knowledge of the critical change in circumstances.

B. Uses of Program-Related Investments

In 2006-2007, approximately 83% of the 494 PRIs surveyed by the Foundation Center consisted of loans, 4.1% were equity investments, and between 1.0 and 1.6% each were business startups/expansion, loan guarantees, cash equivalent deposits, and lines of credit.[46] While these figures represent the majority of PRIs, so long as the investment meets the 3-prong test set forth above, the investment may qualify as a PRI without falling into one of these categories.

PRIs are used for many purposes. They have a unique ability to address areas where the for profit market fails to operate due to lack of financial incentive, for example, PRIs can be used to incentivize for profit companies to create vaccines and medicines in developing countries where the market would not support such activities. Likewise, PRIs are often employed to support economic development in deteriorated urban areas, undeveloped rural areas, or to support businesses owned by economically disadvantaged groups. PRIs can even be used to provide financial support to socially and economically disadvantaged individuals allowing them to go to college or find gainful employment. PRIs are becoming increasingly popular in the context of microfinance allowing foundations to make investments either directly for microfinance or through the use of intermediaries such as MicroCredit Enterprises, a public charity that provides microfinancing to alleviate poverty. In each example, the key is finding an exempt purpose to be accomplished by the investment that is consistent with the foundation's exempt purpose. Where such an exempt purpose can be found and where the parties are willing to structure the investment to meet the other two tests set forth in the Code, PRIs can be a tremendous source of private capital to accomplish socially-beneficial goals.

C. Program-Related Investments and the Private Foundation Prohibitions

1. Minimum Distribution Requirement

An investment that qualifies as a program-related investment will be a qualifying distribution as its primary purpose is to accomplish one or more of the purposes set out in Section 170(c)(2)(B).[47] Because program-related investments count as qualifying distributions in the year made and thus count "against" the five percent (5%) requirement, some foundations view this as a "built-in" five percent (5%) return in addition to what other rate of return the foundation generates from the PRI. In other words, if a private foundation makes a $500,000.00 PRI, that PRI counts as a qualifying distribution in the year made (i.e. it counts as a part of the 5%). Additionally, the PRI reduces the foundation's asset base upon which the five percent (5%) annual distribution requirement is applied by $500,000.00 for each year that the PRI is outstanding. Thus if the foundation is earning two percent (2%) interest on a $500,000.00 loan that is outstanding for five (5) years, the foundation treats the $500,000.00 as a qualifying

[46] *See* Steven Lawrence, *Doing Good with Foundation Assets: An Updated Look at Program-Related Investments* (visited Nov. 29, 2016) <http://foundationcenter.org/gainknowledge/research/pdf/pri_directory_excerpt.pdf>.
[47] *Cf.* Reg. § 53.4944-3 and IRC § 4942(g).

distribution in the year made and applies the five percent (5%) payout requirement against the foundation's assets after the asset base has been reduced by the principal amount over the remaining term of the loan. In the year in which the loan is repaid, there is a "recapture" which operates as an income modification under section 4942(f)(2)(c) of the Code, with the principal repayment effectively being added to the minimum distribution requirement of the year in which the recapture is made.

2. Excess Business Holdings

Section 4943 of the Code restricts a foundation's ability to take an ownership interest in a business enterprise above certain permitted holdings to prevent private foundations from having an advantage over other businesses which operate in the taxable income sector. Specifically, a foundation may own twenty percent (20%) of the voting interest in a business enterprise, reduced by the percentage of voting stock held by all disqualified persons.[48] Where the control of the entity can be shown to be held by non-disqualified persons, the foundation and the disqualified persons may own up to thirty-five (35%) of the entity's voting interest.[49] The foundation may hold a non-voting interest, but only if all disqualified persons together hold no more than twenty percent (20%) of the voting interest or no more than thirty-five percent (35%) of the voting interest if effective control is with a non-disqualified person.[50] The foundation may own a *de minimis* two percent (2%) of the voting stock or value.[51] Section 4943 includes a period of time within which a private foundation must dispose of excess business holdings where such excess business holdings were acquired by gift or bequest.[52] Where a foundation has excess business holdings, it is subject to an excise tax related to same.[53]

In order to be considered a "business holding" for purposes of the excess business holdings rules, holdings must be of a "business enterprise." Section 4943(d)(3) provides that the term "business enterprise" does not include a functionally related business or a trade or business at least ninety-five percent (95%) of the gross income of which is derived from passive sources. TREASURY REGULATION Section 53.4943-10(b) further clarifies that "business holdings do not include program-related investments." Accordingly, whereas foundations are significantly limited in their ability to hold stock of a business enterprise, that limitation does not apply where the investment qualifies as a program-related investment.

3. Jeopardizing Investments

Private foundations must not make investments which would jeopardize the carrying out of the exempt purpose of the foundation.[54] There is no *per se* type of jeopardizing investment. Rather, the rule requires close scrutiny of the foundation manager's standard of care, holding such managers to a "prudent investor" standard of care and requiring that care be exercised in the

[48] IRC § 4943(c)(2)(A).
[49] IRC § 4943(c)(2)(B).
[50] IRC § 4943(c)(2).
[51] IRC § 4943(c)(2)(C).
[52] Reg. § 53.4943-6.
[53] IRC § 4943(a)(1).
[54] IRC § 4944.

consideration of investments looking to both the long-term and short-term interests of the foundation.[55]

Program-related investments are specifically noted to be an exception to the jeopardizing investment prohibition.[56] In other words, the Code recognizes that investments that qualify as program-related investments (i.e. no significant purpose is the generation of income or appreciation of property) would otherwise constitute jeopardizing investments. Congress made a policy decision to allow foundations to make such investments because these investments are made specifically for the purpose of accomplishing the foundation's exempt purposes. However, caution is urged to ensure that an investment will qualify as a program-related investment, as failing PRI status, these types of investments would often otherwise constitute jeopardizing investments. For example, an investment that is not on commercial terms and carries significant risk (one that might otherwise qualify as a PRI) that allows for the funds to be used for political intervention (thereby destroying qualification as a PRI) would likely constitute a jeopardizing investment.

D. Other Treatment of Program-Related Investments

1. *Tax on Net Investment Income*

Pursuant to section 4940(a) of the Code, private non-operating foundations are subject to an excise tax of two percent (2%) on their net investment income.[57] This excise tax on net investment income is not avoidable; however, it can be reduced to one percent (1%) where the foundation can demonstrate that its qualifying distributions paid out before the end of the tax year equal or exceed the sum of (a) the five-year average payout times current year assets, plus (b) one percent (1%) of net investment income.[58] Net investment income equals gross investment income (the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties, and income from other sources similar to those in the preceding list) plus net capital gain, minus all ordinary and necessary expenses paid or incurred for the production or collection of such income, including brokerage fees, investment management fees and director fees applicable to managing the investments.[59]

The section 4940 excise tax on net investment income applies to income generated from all investments; there is no exception for income from PRIs. As such, where PRIs generate interest, dividends, rents, royalties, or similar income, such amounts will be subject to the net investment income tax. Additionally, where a PRI is structured as an equity investment and results in capital gains, such gains are also taxable under section 4940 of the Code.[60] Foundations should take note, however, that there is an exclusion from gross investment income from capital gains or losses resulting from property used for a foundation's exempt purposes for

[55] Reg. § 53.4944-1(a)(2)(i).
[56] IRC § 4944(c).
[57] IRC § 4940(a).
[58] IRC § 4940(e)(2).
[59] IRC § 4940(c)(1); Reg. § 53.4940-1(c).
[60] IRC § 4940(c).

at least one year if the entire property is exchanged immediately following such period of use solely for property of like kind which is also to be used primarily for the foundation's exempt purposes.[61]

2. Unrelated Business Taxable Income

PRIs are not subject to the tax on unrelated business income. Unrelated business taxable income ("UBTI") generally arises in two situations; (1) when the charitable organization has income from an unrelated trade or business; or, (2) when the charitable organization has income incurred with respect to debt-financed property.[62] With respect to the first of these two situations, section 512 provides that "unrelated business taxable income" means gross income that is derived by an organization from an unrelated trade or business which is regularly carried on by the organization less certain allowable deductions.[63] Because the definition requires that the income be generated from an "unrelated trade or business," and because PRIs are, by definition, for the primary purpose of furthering one or more of the exempt purposes of the foundation, PRIs are excluded from UBTI. With respect to the second situation, section 514(b)(1)(A)(1) excludes from the definition of "debt-financed property" property substantially all the use of which is substantially related to the organization's exempt purposes.[64] Again, because PRIs, by definition, have a primary purpose of furthering one or more of the exempt purposes of the foundation, PRIs are excluded from the definition of debt-financed property.

VI. MISSION-RELATED INVESTING

A. DEFINING A MISSION-RELATED INVESTMENT

Unlike program-related investments, mission-related investments (MRIs) are not mentioned in the Code or Regulations. Further, no generally agreed upon definition has been adopted by those involved in the mission-related investment space. Very generally speaking, MRIs are investments with a significant purpose of the production of income or the appreciation of property along with a purpose of creating social good. Based on this definition, MRIs can most easily be contrasted with PRIs in that the primary purpose may not be accomplishing a charitable purpose (as is required for a PRI) and producing income is not merely a possibility but an actual objective. Thus, MRIs seek to create positive social impact as well as a financial return through the use of investment dollars of the foundation.[65] A more formal and frequently cited definition comes from the Global Impact Investors Network: "Impact investments are investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return. They can be made in both emerging and developed markets and target a range of returns from below market to market

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[61] IRC § 4940(c)(4)(1).
[62] IRC §§ 512(a)(1), 514(a)(1)(2).
[63] IRC § 512(a)(1).
[64] IRC § 514(b)(1)(A)(1).
[65] *See* David A. Levitt, *Investing in the Future: Mission-Related and Program-Related Investments for Private Foundations*, The Practical Tax Lawyer, Spring 2011 at 34.

rate depending on the circumstances."[66] As reflected in the GIIN definition, impact investments (of which MRI are a type) can be made in for-profit entities seeking to provide social good (such as benefit corporations and social purpose corporations) as well as for-profit companies engaged in an activity that the foundation believes beneficial to a social good the foundation seeks to further.[67] As a result, mission-related investments can be utilized where program-related investments would not be possible either because the legal requirements cannot be met (the investment is one which would likely be made by a typical investor) or because the foundation seeks a higher return or more security than might be possible through a PRI.

In 2011, the Foundation Center commissioned a study of foundations engaging in mission-related investing.[68] Approximately 1,200 foundations (independent, corporate, and community foundations) responded, and of these, 168 claimed to be engaging in some form of mission-related investing.[69] This group of foundations held more than half of the assets of the total group of 1,200 foundations.[70] Thus, while only approximately 14% of the surveyed foundations indicated engagement in mission-related investing, the funds available for mission-related investing were significant. It should be noted that for purposes of the Foundation Center report, mission investing included both the making of PRIs and MRIs.[71] Just less than one quarter of the foundations engaged in mission investing held only MRIs, while one quarter held both PRIs and MRIs.[72] As reflected in these numbers, holding only MRIs is relatively unique; however, for foundations interested in mission investing (i.e., impact investing), MRIs provide a strategic opportunity to complement other investments. In the author's experience, the making of MRIs has only increased since 2011, in part due to the rise of various types of social enterprises (benefit corporations, flexible benefit corporations, social purpose corporations, and L3Cs). As discussed further below, the IRS has also issued a notice removing one potential impediment for foundations concerned with the prudence of making MRIs.

B. LEGAL ISSUES IN MAKING MRIS

MRIs are distinct from PRIs in that they do not meet the definition of a program-related investment under Regulation Section 53.4944. As a result, there is no special tax treatment for MRIs. While supporting program goals of the foundation, these investments are not qualified distributions counted as part of the foundation's mandatory payout. In addition to navigating self-dealing concerns related to co-investments with disqualified persons and considering the unrelated business income tax burden associated with the investment, unlike PRIs, MRIs continue to be subject to the prohibitions on excess business holdings and jeopardizing investments as well. Complying with the prohibition on excess business holdings is relatively straightforward. If a mission-related investment is made by acquiring equity in an active trade or

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[66] Global Impact Investors Network (visited Nov. 29, 2016) <http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html>.

[67] For instance, investment in a company operating in the renewable energy sector.

[68] The Foundation Center, *Key Facts on Mission Investing*, 2011 (visited Nov. 29, 2016) <foundationcenter.issuelab.org/resource/key_facts_on_mission_investing>.

[69] *See id.*

[70] *See id.*

[71] *See id.*

[72] *See id.*

business, the foundation must ensure that the foundation, along with its disqualified persons, do not own more than 20% of the voting interest of the entity (or 35% if the entity is controlled by a third party).[73]

There has historically been some question as to how mission-related investments should be analyzed under the jeopardizing investment rules. Those rules prohibit a private foundation from investing in a manner that jeopardizes the short-term or long-term interests of the foundation.[74] While there are no per se investments that are prohibited and letter rulings are scant, parties making mission-related investments have had to consider whether the investment is prudent, which raises the question of whether considering—or even elevating—non-financial goals alongside financial returns satisfies the duty of prudence as that duty is reflected in Section 4944 and its associated Regulations. In September 2015, the IRS answered this question affirmatively through Notice 2015-62. In this Notice, the IRS clarified that the factors to be considered under Section 4944 when making an investment are not exhaustive and further explained that an investment will not be a jeopardizing investment where the investment has a "special relationship or special value" to the foundation (e.g., where the investment furthers the foundation's mission) provided the investment is made through the exercise of ordinary business care and prudence under state law governing the foundation.[75] Thus, even if social impact is prioritized equal to or above financial return, as long as the foundation exercises due care, the investment will not constitute a jeopardizing investment. Accordingly, a foundation must be aware of state law duties of care applicable to investment decisions.

C. State Law Investment Standards

1. Development of the Law of Prudence

Overlaid onto, and acting as a complement to, common law standards of fiduciary duty (particularly the duty of care) are specific statutory duties and guidance related to the investment and management of the assets of charitable organizations. Understanding how the law of prudent investing has developed in the United States is helpful in understanding the interplay among the various rules.

Common law has long mandated that a trustee investing assets of a trust should do so in a prudent manner.[76] As Professor Susan Gary explains "[t]he prudent standard evolved over time, reflecting changes in the application of the standard and changes and investing practices."[77] As a part of these changes, in 1972 the Uniform Law Commission approved the Uniform Management of Institutional Funds Act (UMIFA) providing uniform rules for investment of funds held by charitable organizations organized as nonprofit corporations, as well as the

[73] *See* IRC § 4943(c)(2)(A), (B).
[74] *See* IRC § 4944.
[75] *See* Notice 2015-62.
[76] *See* Susan Gary, *Is Mission Investing Prudent* (hereafter "Gary") at 15, http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/joint_fall/2008/mission_investing_prudent.pdf (last visited April 21, 2014), citing *Harvard v. Armory*, 26 Mass. (9 Pick.) 446 (1830).
[77] *See id* citing John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 Iowa L. Rev. 641, 643-46 (1996).

expenditure of funds donated as endowments to those organizations.[78] UMIFA was widely adopted and brought clarification to the law of prudent decision making and investments to nonprofit corporations. Part of this clarification was a focus on diversification, total return, and delegation. UMIFA called for investing and spending consistent with a total return theory, but prohibited endowments from spending below historical dollar value. This development of the law of prudence ultimately led to the American Law Institute revising certain provisions of the Restatement of Trusts, resulting in the creation of the Prudent Investor Rule in 1992.[79] The Prudent Investor Rule requires that a trustee invest and manage the funds of a trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.[80]

With UMIFA well-entrenched in the realm of nonprofit corporations and the Restatement of Trusts modified to create the Prudent Investor Rule, in 1994 the Uniform Law Commission approved the Uniform Prudent Investor Act (UPIA) to provide a set of uniform rules with respect to the responsibilities of trustees of trusts. While not specific to charitable trusts, UPIA was and is sufficiently broad to govern charitable trusts with individual or institutional trustees. UPIA has also been widely adopted.[81] UPIA codified the Prudent Investor Rule with respect to trustees of trusts.

Following UPIA's wide adoption and with UMIFA being more than 30 years old, in 2006, the Uniform Law Commission approved the Uniform Prudent Management of Institutional Funds Act (UPMIFA) to update the law of prudence in investments and appropriation for expenditure in the context of nonprofit corporations. UPMIFA has been adopted in 49 states.[82] Building from UPIA, UPMIFA abolished UMIFA's historical dollar value limitation and called for a standard of appropriation and expenditure based upon ordinary care and prudence. UPMIFA draws on the language of UPIA with respect to management and investment of charitable funds making the rules on investing the same whether UPIA or UPMIFA applies.[83] While there are differences between UPIA and UPMIFA, when considering investment decisions, both UPIA and UPMIFA rely on a modified version of the traditional prudent investor rule requiring decision makers to consider the charitable purposes of the organization in making investment decisions, consider economic factors, balance risk and return, and attempt to maximize overall return within the level of risk tolerance acceptable to the charity under its investment policy.[84]

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[78] *See id.* at 16; *see also* Vanguard, *A Brief History of Nonprofit Fiduciary Law in the United States*, available at https://institutional.vanguard.com/VGApp/iip/site/institutional/clientsolutions/endowmentfoundation/NPResourceCenter/fiduciarylawhistory (last visited April 21, 2014).
[79] *See* Restatement (Third) of Trusts § 90 (2007).
[80] *See id*.
[81] *See Uniform Law Commission, Legislative Fact Sheet - Prudent Investor Act*, www.nccusl.org/LegislativeFactSheet.aspx?title=Prudent%20Investor%20Act (last visited April 21, 2014).
[82] *See Uniform Law Commission, Legislative Fact Sheet – Prudent Management of Institutional Funds Act*, www.nccusl.org/LegislativeFactSheet.aspx?title=Prudent%20Management%20of%20Institutional%20Funds%20Act (last visited April 21, 2014).
[83] *See* Gary at 17.
[84] *See id* at 18.

2. UPIA

A trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule. The prudent investor rule provides that a trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee must exercise reasonable care, skill, and caution.[85]

UPIA is based upon modern portfolio theory. A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust. Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

(1) General economic conditions;
(2) The possible effect of inflation or deflation;
(3) The expected tax consequences of investment decisions or strategies;
(4) The role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
(5) The expected total return from income and the appreciation of capital;
(6) Other resources of the beneficiaries;
(7) Needs for liquidity, regularity of income, and preservation or appreciation of capital; and
(8) An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.[86]

A trustee may invest in any kind of property or type of investment consistent with UPIA.[87] However, in choosing investments, a trustee under UPIA must make a reasonable effort to verify facts relevant to the investment and management of trust assets.[88] A trustee must diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.[89] Further, a trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.[90]

A trustee is to invest and manage the trust assets solely in the interest of the beneficiaries. This means the trustee must act exclusively for the beneficiaries, as opposed to acting for the

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[85] Tex. Prop. Code § 117.004(a).
[86] Tex. Prop. Code §117.004(b)-(c).
[87] Tex. Prop. Code §117.004(e).
[88] Tex. Prop. Code §117.004(d).
[89] Tex. Prop. Code § 117.005.
[90] Tex. Prop. Code §117.004(f).

trustee's own interest or that of third parties.[91] If a trust has two or more beneficiaries, the trustee is to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.[92]

In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee. Trustees are obligated to minimize investment and management costs.[93] A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. In choosing to delegate, a trustee must exercise reasonable care, skill, and caution in selecting the agent; establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation. In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

The determination as to whether a trustee has complied with UPIA is based upon the facts and circumstances as they existed at the time of investment.[94]

3. UPMIFA

As referenced above, UPMIFA provides modern articulations of the prudence standards for the management and investment of charitable funds and for endowment spending in the context of nonprofit corporations. In Texas, UPMIFA applies to "institutions" managing "institutional funds" or "endowment funds". "Institution" is defined to include: (1) a person, other than an individual, organized and operated exclusively for charitable purposes; (2) a government or governmental subdivision, agency or instrumentality, to the extent that it holds funds exclusively for a charitable purpose; and (3) a trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated.[95] "Institutional fund" means a fund held by an institution exclusively for charitable purposes. The term does not include: (1) program related assets; (2) a fund held for an institution by a trustee that is not an institution; or (3) a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund.[96]

UPMIFA provides that subject to the intent of a donor expressed in a gift instrument, an institution, in managing and investing an institutional fund, is to consider the charitable purposes of the institution and the purposes of the institutional fund. Each person responsible for managing and investing an institutional fund must manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. Each person responsible for managing and investing an institutional fund must to

[91] Tex. Prop. Code § 117.007.
[92] Tex. Prop. Code § 117.008.
[93] Tex. Prop. Code § 117.009.
[94] Tex. Prop. Code § 117.110.
[95] Tex. Prop. Code § 163.003(4).
[96] Tex. Prop. Code § 163.003(5).

comply with the duty of loyalty imposed by law other than UPMIFA – this is the same as the common law duty of loyalty discussed in Section II above.[97]

Management and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution.[98] Factors that the institution must consider, where relevant, in managing and investing an institutional fund:

(1) General economic conditions;
(2) The possible effect of inflation or deflation;
(3) The expected tax consequences, if any, of investment decisions or strategies;
(4) The role that each investment or course of action plays within the overall investment portfolio of the fund;
(5) The expected total return from income and the appreciation of investments;
(6) Other resources of the institution;
(7) The needs of the institution and the fund to make distributions and to preserve capital; *and*
(8) An asset's special relationship or special value, if any, to the charitable purposes of the institution.[99]

The final factor in the list above (as well as in the UPIA list of factors) provides a state law basis for making mission-related investments and elevating the consideration of non-financial returns. However, the fact that an investment may be mission-related is not enough by itself to demonstrate prudence. Rather, the board of directors of the foundation must continue to follow its normal due diligence practices, obtain appropriate information regarding the investment, and make a thoughtful consideration of the benefits of the investment (financial and non-financial) as well as the risks and costs of the investment including additional costs for analysis of the non-financial return.[100] This process should comply with the foundation's investment policy statement which should be broad enough to include the making of MRIs. Specifically, the policy should provide guidance in balancing mission-related non-financial returns with financial returns to allow the board to determine the amount of risk the foundation should be willing to take based on those return benefits. Ultimately, this process should be documented in the foundation's minutes as well as, where applicable, in recitals of investment agreements.

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[97] Tex. Prop. Code § 163.004(b).
[98] Tex. Prop. Code §163.004(e)(2).
[99] Tex. Prop. Code § 163.004(e)(1).
[100] *See* Joshua Mintz, Chelsey Ziegler, *Mission-Related Investing: Legal and Policy Issues to Consider Before Investing*, (visited Nov. 29, 2016) <https://www.macfound.org/press/commentary/mission-related-investing-legal-and-policy-issues-consider-investing/>.

VII. PUBLIC/PRIVATE PARTNERSHIPS

A. RATIONALE

Foundations routinely collaborate with other foundations and public charities to accomplish joint goals. In addition to this type of collaboration, foundations may also find themselves collaborating with private business (such as funding scientific research) or with governmental entities. While foundations bring significant capital to a number of complex social issues, philanthropy rarely matches the funding deployed for these issues by the state or federal government. For example, philanthropic funding of scientific research is about $4 billion per year compared to $60 billion per year provided by the Department of Defense, the Department of Energy, the National Institutes of Health, and the National Science Foundations.[101] However, what foundations and philanthropic funders bring is more flexible funding which can be accessed without as much administrative red tape and for projects and researchers that may not attract federal funding (such as orphan disease research or younger researchers who do not have a significant track record).[102] Foundations also provide special expertise and the ability to draw together others interested in collaborating and solving the issue at hand. Accordingly, by collaborating with governmental entities, foundations can leverage their resources.[103]

In the same way that a foundation's motivation to enter into a collaboration with another foundation depends upon the goals being pursued and the resources available (both monetary as well as human resources and expertise), so also a foundation's motivation to collaborate with a public entity (whether that be a federal government, state government, or local government) will vary depending upon the circumstances. For example, a foundation committed to improving public education in a certain locale might view the issue as so broad and systemic that it can only be accomplished through collaboration with local school districts and other community partners. Without the buy-in from local government, the foundation would not be able to implement certain programs that involve engaging new teachers, coordinating special programs, and tracking student results. Likewise, a foundation focused on homelessness may find benefit in collaborating with local government to address housing concerns and safety issues. In each instance, the foundation must consider legal issues arising from the collaboration along with more typical programmatic issues.

B. LEGAL ISSUES TO CONSIDER WHEN COLLABORATING WITH GOVERNMENTAL ENTITIES

In pursuing collaboration with a public entity, foundations can utilize strategies already discussed in this article: direct charitable activities such as convening groups to discuss issues of concern to governmental agencies, funding initial pilot programs with the potential of taking part in those programs (including through the creation of a new entity where necessary or advisable),

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[101] Michael Anft, *When Scientific Research Can't Get Federal Funds, Private Money Steps In*, The Chronicle of Philanthropy, Feb. 8, 2015.
[102] *See id.*
[103] For ideas and examples of various government collaboration projects, consider *Community Foundations: Snapshots of Public-Philanthropic Partnerships*, produced by the Council on Foundations. Although focused on community foundations, this publication demonstrates well the varied and significant ways in which grant makers can collaborate with governmental entities.

participating as a funder in a social impact bond/pay for success program utilizing a program-related investment, making a mission-related investment in a pharmaceutical company that is working pursuant to a government grant, serving as a co-funder/coordinating funding, or providing information or funding for research. From participating in housing partnerships utilizing low-income housing credits to co-sponsoring a charitable activity, wide and varied opportunities exist for foundation collaboration with governmental entities.[104] Regardless of the nature of the collaboration, it is imperative that the parties are clear on the goals to be accomplished, the resources and obligations of each party, the timing and milestones that will apply to the collaboration, and in what ways the project will be impacted by public disclosure rules. The details of any one model of collaboration are beyond the scope of this article; however, there are important factors that routinely come into play regardless of the model. The sections below will highlight three of these issues—charitability and mission impact, liability, and intellectual property.

1. Charitability and Mission Impact

As with any collaboration, working with a governmental agency begins with identifying the charitable purpose to be pursued. As one commentator has noted, "[i]t is almost never enough to presume charitability where government has a role…."[105] For an activity to lessen the burdens of government (either as the sole purpose or as a complementary purpose to another charitable or educational purpose) requires a showing that the governmental unit actually considers the activity being pursued by the organization to be its burden and that the activities being pursued by the exempt organization actually lessen such burden. This is a facts and circumstances test.[106] While public-private partnerships and collaborations with governmental entities may in fact satisfy these tests, the exempt organization should nonetheless carefully scrutinize the collaboration and be prepared to demonstrate how the project lessens the burdens of government or satisfies an alternative rationale for charitability. In addition to confirming charitability, the foundation should determine whether the specific purpose of the collaboration is consistent with the foundation's governing documents and its mission.[107] For example, where the governing documents of a low-income housing agency identify a specific geographic area within which the agency will work, the opportunity to collaborate with a for-profit partner or governmental entity outside of that geographic area is not in furtherance of its mission and conflicts with its governing documents absent amendment of those documents. After confirming that the purpose is consistent with its mission, the foundation should seek to ensure that purpose is pursued throughout the collaboration by embedding the purpose into any documentation (e.g., memorandum of understanding, governing documents of a joint venture-type entity, etc.).

Depending on the nature of the collaboration, a new entity may be necessary to house the venture. This is particularly the case where private business may be involved as a participant, or

[104] *See*, e.g., Anne Mackinnon and Cynthia Gibson, *Working with Government: Guidance for Grantmakers*, Grant Craft (visited Nov. 29, 2016) <www.grantcraft.org/guides/working-with-government>.
[105] John Tyler, *Eyes Wide Open—Nonprofits and Public-Private Partnerships*, Vol. 27, No. 2, Taxation of Exempts, Sep./Oct. 2015, at 18.
[106] *See* Robert Louthian, Amy Henchey, *Lessening the Burdens of Government*, 1993 EOCPE Text.
[107] Where the governing documents have a more limited purpose, the foundation board of directors will be faced with a decision of whether to broaden the purpose or pass on the collaboration.

where the foundation and governmental agency have decided to jointly fund and oversee an activity that is both charitable in nature and has been found by the governmental agency to be in the public interest. In the former case, a limited partnership or limited liability company is most typically used. In the latter case, the parties may form a nonprofit corporation that will later be recognized as exempt as an organization described in Section 501(c)(3) of the Code. In choosing a structure, the private foundation must be mindful of the impact on its exempt status. For example, if the nature of the joint venture is an active trade or business, the foundation will be limited in its ownership by the excess business holdings rules unless the venture constitutes a functionally related business or the foundation qualifies its investment as a program-related investment.[108] Additionally, where for-profit parties are involved, the foundation must ensure that charitability will be maintained and that a private interest will not be impermissibly benefited.[109]

The Regulations provide that to be operated for one or more exempt purposes an organization must serve a public rather than a private interest.[110] An organization will be found to primarily serve a private interest as opposed to a public interest unless the private interest served is merely incidental to the public interest.[111] Whether the private interest is incidental to the public interest is determined on a case-by-case basis depending upon the nature of the activities undertaken and the manner by which the public interest is derived.[112] Any private interest must be incidental to the public interest both quantitatively and qualitatively.[113] To be qualitatively incidental, "the private benefit must be a necessary concomitant of the activity which benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting certain private individuals."[114] To be quantitatively incidental, the activity must not provide a substantial benefit to a private person in the context of the overall benefit conferred by the activity to the public.[115] For example, with respect to educational organizations, the dissemination of information and/or training of individuals serve a public interest by increasing the capabilities of those receiving instruction which thereby serves to better the public welfare. Although all educational activities result in private benefit (i.e. students at any school at any level are necessarily benefited), such private benefit is incidental; the ultimate benefit is to the public absent the educational focus being to train students for a single employer. Between case law and pronouncements from the Internal Revenue Service, a set of rules has emerged surrounding joint ventures involving charitable organizations and private parties to demonstrate satisfaction of the private benefit prohibition.[116]

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[108] *See* IRC § 4942(j)(4).
[109] *See* IRC § 501(c)(3); Reg. § 1.501(c)(3)-1(d)(1)(ii); *see also* GCM 39862 (11/21/91).
[110] Reg. § 1.501(c)(3)-1(d)1(ii).
[111] *See* GCM 37789, (12/18/78).
[112] *See* GCM 38459, (7/31/80).
[113] *See* GCM 37789, (12/18/78).
[114] *See id.* (referencing Rev. Rul. 70–186, 1970-1 C.B. 128); *see also* Ltr. Rul. 9615030 (1996).
[115] *See* Rev. Rul. 72–559; Rev. Rul. 73–313.
[116] For a good overview of these rules, *see* Mary Lawler, Neil Rackleff and Nicola Fuentes Toubia, *Public-Private Partnerships: More Useful than You Thought*, 33rd Annual Nonprofit Organizations Institute, January 2016.

2. Liability

In addition to ensuring mission consistency and protection of tax-exempt status, a foundation engaging in collaboration with a governmental entity must be mindful of liability issues unique to this type of collaboration. Governmental entities often enjoy sovereign immunity protecting the governmental entity from being sued without its consent as well as from being subject to liability unless the governmental entity has agreed to pay the judgment.[117] While entering into a contract waives immunity from liability on behalf of the governmental entity under Texas law, it does not waive immunity from suit.[118] As a result, if the foundation enters into collaboration with a governmental entity in Texas pursuant to a contract, it must be cognizant of the governmental entity's immunity from suit and consider the implications of this jurisdictional bar and whether, and under what circumstances, the foundation has permission to file suit.

Absent the ability to file suit and seek relief, it is often the case that liability will fall on the nonprofit partner.[119] In a typical contract, the nonprofit partner would seek to shift liability to the extent possible through indemnification provisions and relying on its contracting party's insurance. Those options are often not available in the context of collaboration with a governmental entity. Many governmental entities are prohibited from providing an indemnification or at least reluctant to do so understanding that providing such indemnification could waive sovereign immunity.[120] A foundation should understand the limits of sovereign immunity before agreeing to an indemnification provision where the government promises to indemnify the foundation "as permitted by law." This may be an empty promise. Further, governmental entities often do not purchase commercial insurance to protect against tort liability risks either as a result of their sovereign immunity or because they self-insure.[121] If the foundation is successful in convincing the governmental entity to provide indemnification, the foundation should include a reference to insurance requirements. For example, the University of Texas offers the following provision as a provision that can be added to any indemnification undertaken by the University with respect to sponsored research: "University, as a component of System, is an agency of the State of Texas and is self-insured pursuant to the University of Texas System Professional Medical Malpractice Self-Insurance Plan, under the authority of Section 59.01, Texas Education Code. University has and will maintain in force during the term of this Agreement adequate insurance to cover its indemnification obligations hereunder."[122] In addition to seeking enforceable indemnification, to address its increased liability exposure as a result of collaborating with a governmental entity, the foundation should consider alternative ways to address the risk including limitations of liability, assumptions of risk, additional

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117 *See Rusk State Hosp. v. Black*, 392 S.W.3d 88, 93 (Tex. 2012).
118 *See First-Citizens Bank & Trust Co. v. Greater Austin Area Telecomms. Network*, 318 S.W.3d 560, 564 (Tex. App.—Austin 2010, no pet.).
119 *See* Tyler, *supra*, at 21.
120 *See id.* at 22.
121 *See* Tyree C. Collier, Suzanne Smith, *Doing More with Less—Public/Private Collaboration as a Key Nonprofit Trend*, 30th Annual Nonprofit Organizations Institute, January 2013, 11.
122 University of Texas System, Office of General Counsel, *Indemnification Sample Clauses* (visited Nov. 29, 2016) <https://www.utsystem.edu/offices/general-counsel/indemnification-sample-clauses>.

insurance, utilizing a subsidiary in the collaboration, and seeking to gain other concessions in the agreement such as increased oversight or greater financial return (as applicable).

3. Intellectual Property

While not present in every collaboration with a governmental entity, again, depending upon the nature of the collaboration, the foundation should thoughtfully seek to negotiate with respect to intellectual property. Intellectual property concerns may arise with respect to the use of the foundation's marks and goodwill, with respect to intellectual property being provided for purposes of pursuing the venture, or with respect to intellectual property being created as a result of the nature. Failing to address intellectual property is an invitation for dispute should the collaboration stall. Additionally, to the extent intellectual property is created that may have commercial value, the foundation should consider whether it is willing to walk away from that potential commercial value, thereby allowing the value to either reside with a commercial partner or the governmental entity, or desires some return from the intellectual property.

This becomes a particularly acute issue when the venture involves supporting research in a particular field that may lead to a commercialize product, such as a new drug therapy. While more involved than intellectual property concerns in other areas, an examination of intellectual property rights to be negotiated in the medical venture area provides a good overview of the complexity and importance of this aspect of the collaboration. For demonstrative purposes, the next section will provide this examination in the context of a foundation providing grant funds to a public university for funded research in the medical field.

C. SPECIAL FOCUS: INTELLECTUAL PROPERTY

1. Ownership of Intellectual Property

With respect to ownership, it is almost always the case that the governmental entity will require ownership of the intellectual property developed from funded research. Ownership of the intellectual property reflects that the transaction is not a fee for service transaction where the work product is to be owned by the customer but rather is funded research with the intellectual property available to the university for future research projects as well as for publication, a key concern of universities. Universities may be willing to divide ownership of intellectual property, allowing the foundation ownership of intellectual property associated with proprietary materials provided by a foundation or a protocol provided by a foundation that is being tested; however, these are unusual situations in the foundation-sponsored research context as compared to the industry-sponsored research context. More typically, a foundation is less interested in ownership of the intellectual property than in the right to use the intellectual property for internal purposes and the right to see that the intellectual property is disseminated for the public good. These concerns can often be met while allowing the university to maintain ownership of the intellectual property.

2. Licensing of Intellectual Property

Foundation access to and use of the intellectual property can most easily be accomplished through a licensing arrangement whereby the university (as owner of the intellectual property) grants the foundation a nonexclusive royalty-free license (NERF) for non-commercial use. A non-commercial NERF license allows the foundation access to the intellectual property without paying any further royalty. At the same time, it is non-exclusive, meaning the university, as owner, can license the intellectual property to another. A non-commercial NERF license is consistent with the funding being that of grant funding as opposed to fee-for-service and allows the university to maintain ownership for purposes of future research and publication while allowing the foundation the right to use the intellectual property internally for research purposes without the fear of violating another party's intellectual property rights.[123] An issue that can arise when a foundation is granted a non-commercial NERF (whether the foundation is seeking to use the resulting intellectual property or is seeking to sub-license the resulting intellectual property to other researchers) is the issue of background intellectual property rights. Essentially, background intellectual property is intellectual property owned by the university or another third party that exists separate and apart from the foundation-funded research but is necessary to use the intellectual property that is created from the foundation-funded research. Universities are reluctant to grant background intellectual property rights, as it requires careful consideration of obligations the university may have to other parties. However, where background intellectual property will be necessary, the foundation should seek access to background intellectual property for non-commercial research purposes as necessary to utilize the foundation-funded intellectual property.

The foundation may wish to ensure that it has the ability to sub-license the subject intellectual property to other researchers (typically also at no cost or only transfer cost) to allow the foundation the ability to get the intellectual property into the hands of other researchers who may advance the research in other ways. When sub-licensing is involved, the foundation should anticipate that the university will seek to protect its right to be first to publish the intellectual property generated as a result of its research.

3. March-In Rights

Accepting a license while allowing the university to maintain ownership of the intellectual property results in the patenting, commercialization, and publication of the data being left to the university. The university may not have the same priorities as the foundation, and these issues may not be effectively accomplished. As a result, the foundation should consider seeking march-in rights, rights to "march in" should the grantee or its licensee fails to take effective steps under reasonable circumstances to bring an invention (however that might be defined) to practical application within a specified time period. These rights may go so far as to allow a cancellation of an exclusive license and assignment of the invention back to the foundation.

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[123] Note that if a NERF is granted, the foundation should anticipate that the university will request indemnification from the foundation with respect to the foundation's use of the intellectual property.

The Bayh-Dole Act provides the federal government march-in rights for certain defined reasons.[124] As a result, universities are familiar with the concept. However, universities are extremely reluctant to agree to any significant march-in right, arguing that such rights make it very difficult for the university to license the intellectual property to a third party for commercialization purposes, as the licensee does not want to risk expending significant funds while a third party (here, the foundation) has the right to march in and cancel the exclusive license if commercialization has not occurred on a timeline agreed to between the foundation and the university, particularly where there may be economic or non-economic reasons to delay or set aside a project. Where a foundation is providing a grant to a university that will in turn license any created intellectual property, such march-in rights are difficult to negotiate.

There are steps that are within the umbrella of march-in rights that can be used by a funder to help ensure that the intellectual property is appropriately commercialized for the public benefit. For example, a foundation may negotiate certain diligence provisions toward licensing the intellectual property for commercialization and may have the university keep the foundation informed (through annual reporting or otherwise) on its exercise of diligence and progress in licensing the intellectual property. This does not grant the foundation the right to "march in" with respect to a third party, but allows the foundation remedies to the extent the university fails to exercise diligence in seeking to license the intellectual property. Likewise, while most universities will themselves seek diligence provisions in their licensing agreements with third parties, the foundation may wish to have the ability to review and approve any exclusive licensing agreements of the intellectual property created by the foundation's funding. Review and approval rights allow the foundation to ensure appropriate diligence provisions are included as well as the ability to consider the appropriateness of the party receiving the exclusive license based on its history, capacity, and other relevant factors. Alternatively, a foundation may require that diligence provisions be included in license agreements without a right to review and approve the license agreements. This alternative would result in the university having greater flexibility in entering into licensing agreements (because it does not require foundation approval) but allows the foundation to retain a remedy for breach of contract in the event the university fails to include diligence provisions.

4. Royalty Sharing

Many research funders additionally negotiate rights to share in any royalties resulting from the intellectual property created by the foundation-funded research. A critical issue in this regard is arriving at an equitable figure, which may be stated as a flat-rate, a multiple of sales, or a percentage of the net proceeds allocable to the invention resulting from the foundation's funding (any of the foregoing of which could be capped). The goal is achieving an equitable solution considering all of the factors leading to the invention. For example, while a foundation may have provided only twenty-five percent of the funding, that twenty-five percent may have been the initial seed capital and receive what is, in effect, a preferred return. On the other hand, the university may already have agreements with other parties that impact on the sharing allocation. Finally, a foundation should recognize what the university has invested (through facilities, resources, etc.), which the overhead charge paid by the foundation will rarely cover.

[124] *See* 35 U.S.C § 200 et seq.

For example, the University of Pennsylvania has guidelines specifying that royalties will only be shared where the foundation has paid for all facility and administrative costs associated with the research project, including the effort of the principal investigator, or has agreed that the royalty sharing will only begin after the facilities and administrative costs have been subtracted from the sponsor's share and provided to the university.[125] An excellent overview of royalties and monetization (though more focused on grant awards made to for-profit pharmaceutical companies) can be found at *Venture Philanthropy Legal Report* Spring 2012 #3: *Everything You Ever Wanted to Know About Royalties and Their Monetization but Were Afraid to Ask* (available at schanerlaw.com/wp-content/uploads/2014/07/SLPLLC_Spring_2012.pdf, last accessed April 7, 2015).

VIII. CONCLUSION

When thinking about private foundations, making gifts and grants typically comes to mind; however, foundations have always had an opportunity to go beyond grant making in pursuing their mission. Whether through direct charitable activities, impact investing (both program-related investing and mission-related investing), or engaging in partnerships with other foundations, for-profit partners, or governmental entities, foundations have flexibility to pursue mission while continuing to satisfy the foundation requirements under the Code. As today's foundations become more entrepreneurial in nature, these other avenues for mission continue to grow in importance bringing together the expertise of foundations, their staff, their grantees, and their partners to achieve the greatest impact.

[125] *See* Guidelines on Foundation Intellectual Property Issues (upenn.edu/researchservices/pdfs/ngoip-guide.pdf, last accessed April 7, 2015).