NOTE

SCARCITY AMIDST WEALTH: THE LAW, FINANCE, AND CULTURE OF ELITE UNIVERSITY ENDOWMENTS IN FINANCIAL CRISIS

Peter Conti-Brown*

The financial crisis of 2007-2009 left elite university endowments with 30% less value, causing these universities to respond with dramatic budgetary restructuring. While endowments had received probing national and congressional attention in the months prior to the crisis, that attention largely gave way to the conventional view that universities were no longer able to meet their budgetary needs because of these endowment losses. This wisdom took hold despite the fact that elite universities still sat atop multibillion dollar endowments designed, at least in theory, to provide a cushion in times of financial distress.

This Note explores this puzzle by looking at the legal and financial restrictions placed on endowment spending. The Note finds that, arguments to the contrary notwithstanding, the law does not meaningfully restrict elite universities in their spending, largely because the law does not apply to unrestricted funds that compose almost half of elite universities' endowments. A somewhat stronger explanation is financial: elite university investment in illiquid assets means that universities cannot cash out endowments to stabilize their budgets because of an inability to access those investments. I argue, however, that the financial explanation is still inadequate because illiquid investments likely accounted for a minority of each elite university's endowment. The Note articulates a different theory of endowment value: universities use their endowments as a symbol of prestige and a point of competition between peer institutions. The cultural value of university endowments means that universities will strive to avoid endowment

* Academic Fellow, Rock Center for Corporate Governance, Stanford University. My appreciation to Bob Weisberg, Norman Spaulding, and my outstanding colleagues in Stanford Law School's Legal Studies Workshop. Thanks also to Rakesh Kilaru, Michael Klausner, Lawrence Mitchell, Jacek Pruski, Felix Salmon, David Skeel, Gordon Smith, and especially Nikki Conti-Brown for superb comments and criticism. Special thanks to Britton Olson for programming tutelage and general advice on data visualization. My warmest thanks to the staff of the Stanford Law School Library for their endless patience and hard work on my behalf.

liquidation to the fullest extent possible, even, counterintuitively, in times when they need their endowment funds most of all.

INTRODUCTION—ENDOWMENTS IN CRISIS?

In late 2007 and early 2008, Senators Max Baucus (D-Montana) and Chuck Grassley (R-Iowa)—Chairman and Ranking Member, respectively, of the Senate Finance Committee (SFC)—called higher education to attention by opening an inquiry into how elite universities manage their multibillion dollar endowments.[1] Commentators during the previous decade had extolled the genius of elite universities' investment management departments,[2] and now the Senators and others began asking the important question: to what end the accumulation of so much wealth? Indeed, the Senators' own questions carried added bite. They asked universities to provide detailed information regarding endowment restrictions, financial aid policies, student demographics, and the average amount that families must pay for students to attend the universities.[3] Additionally, the Senators and others explicitly challenged one of higher education's sacred cows: its favorable tax treatment under § 501(c)(3) of the Internal Revenue Code.[4]

Soon, however, the inquiry skidded to a stop.[5] Along with most other participants in the global financial market,[6] university endowments were severely battered by the financial crisis of 2008.[7] The early estimates predicted

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1. Karen W. Arenson, *Senate Looking at Endowments as Tuition Rises*, N.Y. TIMES, Jan. 25, 2008, at A1.

2. *See* Chris Arnold, *Yale's Money Guru Shares Wisdom with the Masses*, NPR (Oct. 5, 2006), http://www.npr.org/templates/story/story.php?storyId=6203264; Marc Gunther, *Yale's $8 Billion Man*, YALE ALUMNI MAG., July/Aug. 2005, *available at* http://www.yalealumnimagazine.com/issues/2005_07/swensen.html; Charles Stein, *Harvard's $12 Billion Man*, BOS. GLOBE, Oct. 17, 2004, at D1.

3. Press Release, U.S. Senate Comm. on Fin., Baucus, Grassley Write to 136 Colleges, Seek Details of Endowment Payouts, Student Aid (Jan. 24, 2008), *available at* http://finance.senate.gov/press/Gpress/2008/prg012408f.pdf. In a more colorful description of the problem, Senator Grassley noted that if milk and gas had increased at the same rate as tuition since 1980, Americans in 2008 would pay $9.15 per gallon of gas and $15 per gallon of milk. Press Release, Senator Chuck Grassley, Endowments May Help Rein In Tuition Hikes (Oct. 29, 2007), *available at* http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=14508.

4. Sally G. Blinken & Ann Thomas, *Colleges and Universities: The Next Target of Audits, Investigations and Legislative Reform?*, UNIVERSITYBUSINESS.COM (Mar. 2009), http://www.universitybusiness.com/viewarticle.aspx?articleid=1254 (noting that Senators Baucus and Grassley convened a roundtable titled "Maximizing the Use of Endowment Funds and Making Higher Education More Affordable," and mentioning the § 501(c)(3) status of the universities). Interest in large university endowments' special treatment under the tax code had been actively building in the Senate for at least a year. *Offshore Tax Issues: Reinsurance and Hedge Funds: Hearing Before the S. Comm. on Fin.*, 110th Cong. 2-3 (2007) (statement of Sen. Chuck Grassley, Ranking Member, S. Comm. on Fin.).

5. There have been some efforts in Congress to continue agitating for endowment-oriented legislation. *See* Isaac Arnsdorf, *Congress May Still Mandate Spending*, YALE DAILY NEWS, Jan. 14, 2009, http://www.yaledailynews.com/news/2009/jan/14/congress-may-still-mandate-spending (citing Vermont Democratic Congressman Peter Welch's introduction of a mandatory payout obligation for endowments and Senator Grassley's continued support for such legislation). By and large, efforts to mandate endowment spending or revoke the tax-exempt status have receded from the front pages of newspapers and business magazines.

6. Not every participant, of course. *See* MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010).

7. Deborah Brewster, *Yale Fund Loses 25% in Four Months*, FIN. TIMES (London), Dec. 17, 2008, at 5; John Hechinger & Craig Karmin, *Harvard Hit by Loss as Crisis Spreads to Colleges*, WALL ST. J., Dec. 4, 2008, at A1; Katie Zezima, *Data Show College Endowments Lost 23% in 5 Months, Worst Drop Since '70s*, N.Y. TIMES, Jan. 27, 2009, at

an average loss of 23% of endowment value in only five months.[8] The political momentum that had grown around Senators Baucus and Grassley seemed to dissipate while many elite universities scrambled to make sense of budgets that had not anticipated the endowment losses. Roughly a year after the SFC's questionnaire dominated news in higher education,[9] the news shifted to focus on university endowments' increasingly dire financial straits and the university budget cutting that soon followed. Even the most elite universities, with the largest endowments, were not immune. Consider the various responses to the financial crisis from the five private American universities with the largest endowments, measured by absolute dollar value—Harvard, Yale, Stanford, Princeton, and MIT. The schools variously have cut budgets up to 15%,[10] laid off hundreds of employees,[11] frozen salaries,[12] halted or delayed construction projects,[13] issued billions of dollars in debt,[14] canceled or downgraded varsity sports teams,[15] and closed libraries,[16] among many other responses.[17] By every

A17. I will refer throughout this Note to the "financial crisis of 2008," and mean by it the combined failure of the market for subprime mortgages; the collapse of the collateralized debt obligation (CDO) market; the failure of large financial institutions such as Bear Stearns, Lehman Brothers, Freddie Mac, Fannie Mae, Washington Mutual, and American International Group (AIG); and the consequent market upheaval that continues to unfold at the time of publication.

8. Zezima, *supra* note 7.

9. *See* Arenson, *supra* note 1; *see also* Goldie Blumenstyk, *Market Collapse Weighs Heavily on College Endowments*, CHRON. HIGHER EDUC. (D.C.), Feb. 6, 2009, at 17; Robert Tomsho, *Bulging Endowments Stir College-Aid Debate*, WALL ST. J., Jan. 24, 2008, at D3.

10. Michael McGraw-Herdeg & Robert McQueen, *Institute to Cut Budget, Slow Hiring*, TECH, Nov. 18, 2008, at 1, 11.

11. *See* Peter Henderson, *Stanford University Endowment Drop Forces Layoffs*, REUTERS (Sept. 2, 2009), http://www.reuters.com/article/rbssTechMediaTelecomNews/idUSN0231518720090902?sp=true; Oliver Staley, *Stanford Business School Fires 49 Employees, About 12% of Staff*, BLOOMBERG (Jan. 22, 2009), http://www.bloomberg.com/apps/news?pid=20601103&sid=aJiP5b4ARCkc&refer=us.

12. *See* Tracy Jan, *Harvard Imposes Salary Freeze, Postpones Faculty Searches*, BOS. GLOBE, Dec. 9, 2008, http://www.boston.com/news/local/breaking_news/2008/12/harvard_imposes.html; David Shieh, *Princeton Slashes Its Budget Again and Freezes Salaries*, CHRON. HIGHER EDUC. (D.C.), Apr. 9, 2009, http://chronicle.com/article/princeton-slashes-its-budget/42708.

13. *See* Janet Frankston Lorin, *Yale Delays Building Projects, Curbs Pay Increases*, BLOOMBERG (Feb. 24, 2009), http://www.bloomberg.com/apps/news?pid=20601103&sid=apfouF6mI3wA&refer=us; June Q. Wu & Peter F. Zhu, *Harvard to Delay Allston Construction*, HARV. CRIMSON, Feb. 19, 2009, http://theharvardcrimson.com/article/2009/2/19/harvard-to-delay-allston-construction-span.

14. *See* Gillian Wee, *Princeton, Harvard Lead Bond Sales as Endowments Fall*, BLOOMBERG (Jan. 14, 2009), http://www.bloomberg.com/apps/news?pid=20601110&sid=aZbefB1CWaAI; Press Release, Stanford Univ., Stanford Plans Upcoming Debt Offering (Apr. 22, 2009), *available at* http://news.stanford.edu/news/2009/april22/bond-042209.html.

15. *See* Cate Doty, *To Save Money, M.I.T. Drops 8 Sports Teams*, N.Y. TIMES, Apr. 25, 2009, at A12; Bonnie J. Kavoussi & Esther I. Yi, *FAS Announces Broad Array of Budget Cuts*, HARV. CRIMSON, May 11, 2009, http://www.thecrimson.com/article/2009/5/11/fas

account, universities—including the wealthiest in the country—have made significant cuts to almost every area of their budgets. At first blush, this sudden change has a seductive logic. Yale's President Richard Levin describes the sudden change in attention—from concerns about the ever-growing endowment to concerns that universities cannot finance themselves—in these terms: "We had a run that was historically unprecedented, and at the tail end of that it looked like we were getting too rich . . . . Well, [that view has] quickly been amended."[18] Excessive wealth, lost quickly, suddenly does not look excessive.

This view, however, leaves many questions unanswered. Even postcrisis, elite universities sat atop multibillion dollar endowments: why, then, did they not spend down more of these cash reserves rather than inflict significant disruption to their operating budgets?

Universities and other commentators, to the extent they have engaged the question at all, have produced roughly three answers: (1) during times of plenty, universities spent at levels that the postcrisis endowment could not sustain; (2) the law prevented universities from spending their endowments however they saw fit, which stood in the way of using endowment funds during times of crisis; and (3) elite endowments were invested in funds and assets that were difficult to access, particularly during times of crisis, making their use for budgetary stability impossible.

This Note argues that these explanations, with respect to elite universities,[19] are wrong: universities did not spend beyond their means during times of plenty, the law does not meaningfully restrict elite universities in endowment spending, and universities could and did access even the most illiquid of investments during the crisis months with relative ease.

-announces-broad-array-of-budget (announcing Harvard's "downgrading of three junior varsity teams to club status").

16. *See* Arkajit Dey, *MIT Libraries Lays Off Staff, Plans to Close Two Branches*, TECH, Mar. 13, 2009, at 1.

17. Kavoussi & Yi, *supra* note 15. Appendix A provides a fuller account of these five schools' budgetary reactions to the crisis.

18. Matthew Kaminski, *The Weekend Interview with Richard Levin: The Age of Diminishing Endowments*, WALL ST. J., June 6, 2009, at A11.

19. By elite universities, a term I use throughout the Note, I refer only, and somewhat arbitrarily, to the five private universities with the largest endowments in absolute value. They are (1) Harvard, (2) Yale, (3) Stanford, (4) Princeton, and (5) MIT. This Note focuses only on private schools to eliminate the confusing interference of state funding. The use of the absolute value is also nonobvious. Other methods include endowment-to-expense ratios—that is, how many times larger the university's endowment is to its annual expenses. Sarah Waldeck argues persuasively, however, that these ratios are inferior to a measure of endowment per full-time enrolled student. *See* Sarah E. Waldeck, *The Coming Showdown over University Endowments: Enlisting the Donors*, 77 FORDHAM L. REV. 1795, 1799-802 (2009). Because this Note explicitly embraces the role of the endowment as popularly conceived, I follow the conventional—though admittedly problematic—standard of absolute value, except where otherwise explicitly identified.

Instead, this Note argues, universities have come to view their endowments as having value independent of the financial wealth such funds represent. That is, rather than simply an accumulation of excess capital, an elite university's endowment represents a symbol of status and prestige, similar to the university's libraries, art museums, architecture, faculty, and the prominence of its alumni. And just as an elite university would never sell its libraries, art museums,[20] or architecture, so too will universities reach for any number of alternative funding sources—including their operating budgets—to avoid increased deterioration of their endowments. In that sense, universities' endowments are like cowboys' belt buckles: the bigger the buckle, the more impressive the cowboy. Even though a university's endowment may be adequate for its investment and budgetary funding purposes at one level, the larger the endowment, the more powerful the signal of excellence that the endowment represents.

The Note proceeds in six Parts. Part I discusses the theoretical explanation of university endowments, to the extent that that explanation has been articulated. This theoretical articulation would suggest that universities would spend more heavily from their endowments during times of crisis, not less. Part II introduces data from the top five private universities during the ten years prior to the crisis to explain that the claims that universities overspent during times of plenty does not gel with the data on endowment and budget growth. Part III explains the relevant legal framework for university investment management and articulates why the restrictions that the law imposes on nonprofit investment management are almost certainly inapplicable to large universities with old endowments. Part IV explains why the liquidity crisis explanation, while certainly the most credible of the theories advanced so far, is undermined both by the disclosed composition of university endowments, and by the universities' actual practices during the crisis itself.

Part V introduces the Note's novel explanation for university behavior and articulates a theory of the endowment's cultural significance. Under this theory, a university is reluctant to spend anything but the bare minimum because the endowment itself is a valuable and meaningful signal, particularly as compared to peer institutions. In this sense, a university has strong incentives to grow its endowment beyond any obligation to pay current expenses or support present students. Part VI concludes with a discussion of what the notion of a cultural endowment might mean for universities, and for those who may, in the future,

20. Brandeis University in Waltham, Massachusetts provides an example of a university that, facing financial crisis, nearly did liquidate its $350 million art museum. *See* Tracy Jan & Peter Schworm, *Donation Drop Puts Brandeis in a Bind*, BOS. GLOBE, Feb. 5, 2009, at B1. But Brandeis is the exception, and outside of the scope of this Note. Because of its relative youth, its endowment has not had time to mature and faces restrictions that do not apply to older, wealthier universities. Additionally, Brandeis depends more heavily on current donors to fund its operating budget. In addition to experiencing losses due to the financial crisis, many Brandeis donors were among those defrauded by Bernard Madoff. *Id.*

again question whether universities should continue to accumulate wealth for this cultural purpose.

In the months since the worst of the crisis, universities have regrouped,[21] and, in some cases, changed some of their approaches to investment.[22] Nevertheless, future crises will come; these universities will suffer endowment losses again. And when they do, the appeal of endowment retrenchment at the expense of budgetary restructuring may prove more than the various university administrations can resist. This Note is an effort to understand why and how this curious dynamic occurs at all.

I. THE THEORY OF UNIVERSITY ENDOWMENTS

In order to understand why the conventional explanations of universities' budgetary skittishness in the wake of endowment loss are incomplete, we must first understand the basic theoretical explanation for why universities have endowments in the first place. In a seminal and still insufficiently engaged article, Henry Hansmann provides the most plausible explanations for why universities have endowments, and probes whether those explanations make analytical sense.[23] What follows in this Part is a summary of these arguments, including subsequent scholars' somewhat scattered efforts to build on Hansmann's work, as well as an illustration of how elite university reactions to the financial crisis undermine some theories and bolster others. Ultimately, the conclusion that universities use their endowments as a symbol of prestige and a point of competition supports Professor Hansmann's dissatisfaction with the theories he surveyed.

It is not obvious why universities maintain large capital reserves at all—particularly in contrast to the general habits of private corporations and even

21. *See* Geraldine Fabrikant, *Harvard Endowment Reports 11% Return for Year*, N.Y. TIMES, Sept. 10, 2010, at B3 (highlighting Harvard's impressive postcrisis return); Press Release, Mass. Inst. of Tech., MIT Releases 2010 Endowment Figures (Sept. 27, 2010), *available at* http://web.mit.edu/newsoffice/2010/endowment-0927.html (announcing MIT's 10.2% endowment return); Press Release, Princeton Univ., Princeton Endowment Earns 14.7% Return (Oct. 15, 2010), *available at* http://www.princeton.edu/main/news/archive/S28/71/07M45/index.xml?section=topstories (announcing Princeton's endowment return for fiscal year 2010); Press Release, Stanford Univ., Stanford Management Company Announces 2010 Results (Sept. 28, 2010), *available at* http://news.stanford.edu/news/2010/september/merged-pool-return-092810.html (announcing Stanford's 14.4% return for fiscal year 2010); *Yale Endowment Grows by 8.9%, a Gain of $1.4 Billion*, YALE DAILY BULL. (Sept. 24, 2010), http://dailybulletin.yale.edu/article.aspx?id=7789 (announcing Yale's returns for fiscal year 2010).

22. *See* Gillian Wee, *Fixing Harvard Endowment Failures Will Take Mendillo Five Years*, BLOOMBERG (Sept. 28, 2010), http://www.bloomberg.com/news/2010-09-28/failures-of-harvard-endowment-will-take-five-years-to-fix-in-mendillo-plan.html (highlighting Harvard's endowment manager's efforts to sell off some of its private equity holdings).

23. Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3 (1990).

universities in other parts of the world, like Japan.[24] Hansmann surveys eleven possible theories, and explains their strengths and weaknesses.[25] These theories include the needs to maintain intergenerational equity, to smooth "lumpy funding," to exploit the tax system on behalf of the university, to maintain liquidity, to provide long-term security, to provide insulation from outside demands, to subsidize values, to satisfy the preferences of donors, to satisfy the preferences of administrators and faculty, to fulfill the peculiar perspective of trustees, and simply to conform to custom and habit.

Unlike Hansmann, I assume that universities are rational in their practice of endowment maintenance. I seek not to understand *why* universities have endowments at all, but only to understand whether the theories articulated by universities to defend the practice of endowment accumulation make sense in light of their reactions to the financial crisis. Thus, I address only the two most frequently invoked theories that Hansmann describes: intergenerational equity and the endowment as a rainy day fund.[26]

A. *Intergenerational Equity*

Of the theories that Hansmann surveyed to explain the existence of university endowments, the idea of intergenerational equity has received the most attention from commentators. In the words of prominent economist James Tobin:

> [The university trustees'] task is to preserve equity among generations. The trustees of an endowed university . . . assume the institution to be immortal. They want to know, therefore, the rate of consumption from endowment which can be sustained indefinitely. . . . Consuming endowment income so

24. *See id.* at 3-4.

25. Indeed, Hansmann concludes his analysis unsatisfied with prevailing explanations for why universities have endowments. His challenges are difficult to rebut; no one in the academic literature has succeeded in doing so in the nearly twenty years since he first wrote. *See* Mark J. Cowan, *Taxing and Regulating College and University Endowment Income: The Literature's Perspective*, 34 J.C. & U.L. 507, 525-34 (2008); Robert C. Merton, *Optimal Investment Strategies for University Endowment Funds*, *in* STUDIES OF SUPPLY AND DEMAND IN HIGHER EDUCATION 211, 211-12 (Charles T. Clotfelter & Michael Rothschild eds., 1993). Because this Note is aimed at understanding university behavior in light of financial crisis, I assume, perhaps implausibly, that universities do have sensible reasons for maintaining endowments, that these reasons track those offered by Hansmann, and that any future treatment of endowment funds will track these explanations. My conclusions from this analysis only bolster Hansmann's initial suspicions that explanations of purely economic motives for maintaining large capital reserves are inadequate to describe university behavior.

26. Interested readers should, of course, delve more deeply into Hansmann's excellent analysis for the fuller articulation of the puzzle of university endowments' existence in the first place.

> defined means in principle that the existing endowment can continue to support the same set of activities that it is now supporting.[27]

In other words, the university must use its endowment to provide the same level of services to tomorrow's university community as it provides to today's.

The idea of intergenerational equity continued to resonate with university administrators, at least while Congress focused on university endowment spending practices in 2007 and 2008. The American Association of Universities (AAU), in an effort to provide the universities' perspective on endowment spending, claimed that intergenerational equity justified universities' low payout rates. In a document entitled *Facts About College and University Endowments*, the American Council on Education, the Association of American Universities, the National Association of Independent Colleges and Universities, and the National Association of State Universities and Land-Grant Colleges described intergenerational equity as the principle that "ensures that future generations of students and faculty receive at least the same level of support from an institution's endowment as the current generation enjoys. Typical spending policies aim to prevent weak investment returns from forcing commensurate decreases in spending."[28]

Hansmann finds that the theory "provide[s] very doubtful support for current endowment policies."[29] Hansmann argues that intergenerational equity, as an initial matter, runs "strongly counter to prevailing notions of equity" largely because the next generation will likely be wealthier than the current.[30] Therefore, denying access to capital today in order to provide that same capital tomorrow would effectively transfer wealth from the poor to the rich, relatively speaking. Hansmann constructs a basic mathematical model to demonstrate why universities interested in intergenerational equity could reasonably spend excess capital rather than save it.[31] Additionally, Hansmann makes several other arguments against the assumptions of those who point to intergenerational equity as a justification for university endowments. These challenged assumptions include that: (1) we must exclude future gifts when planning for a university's future, (2) an endowment is necessary to provide the same level of services to future generations of students, (3) universities are well positioned to engage in efficient wealth transfer across generations, and (4) *financial* accumulation is the most effective means for engaging in intergenerational wealth transfer.[32]

27. James Tobin, *What Is Permanent Endowment Income?*, 64 AM. ECON. REV. 427, 427 (1974).

28. AM. COUNCIL ON EDUC. ET AL., FACTS ABOUT COLLEGE AND UNIVERSITY ENDOWMENTS (2008), *available at* http://www.aplu.org/NetCommunity/Document.Doc?id=577.

29. *See* Hansmann, *supra* note 23, at 14.

30. *Id.*

31. *Id.* at 41-42.

32. *Id.* at 14-19.

Extending or challenging Hansmann's critical analysis of intergenerational equity would require a discussion of a different sort than the one undertaken here.[33] Let us therefore concede, unlike Hansmann, that universities rationally intend to honor intergenerational equity, and that the most effective means for doing so under regular circumstances is withholding capital from students today for the benefit of students tomorrow.

In that case, universities' reactions to the financial crisis suggest some degree of dissonance. First, by cutting operating budgets—by increasing section sizes, closing libraries, cutting sports teams, and closing academic programs[34]—universities have violated the intergenerational equity pledge. Students yesterday were supposed to have benefits withheld in order to ensure that students today received at least the same benefits. Under the present practice, however, students yesterday received benefits that students today no longer receive, making the promise of intergenerational equity hollow.

Some have argued that these sacrifices are insignificant, or simply provide an opportunity to make strategic decisions about the financial health of a university.[35] But this argument is beside the point: while the cuts made to the budget may have represented appropriate efforts to rein in the worst of elite university profligacy, they also represent the practice of removing benefits from a generation of students that had been provided to a previous generation. This dissonance within intergenerational equity can mean, then, that if intergenerational equity was ever a controlling motivator for universities, it is not such a force today.

B. *A "Rainy Day" Fund*

There is a second, related justification for endowments implicated by the financial crisis: endowments function as a sort of rainy day fund for universities. This is analytically distinct from the principle of intergenerational equity: a rainy day fund is meant simply to tide over universities during times when other funding sources become less available. The endowment, then, will

33. Interestingly, despite the prominence of Hansmann's critique, commentators continue to invoke intergenerational equity as a justification for endowment accumulation, without engaging Hansmann's counterarguments. *See, e.g.*, AM. COUNCIL ON EDUC. ET AL., *supra* note 28; Roger T. Kaufman & Geoffrey Woglom, *Modifying Endowment Spending Rules: Is It the Cure for Overspending?*, 31 J. EDUC. FIN. 146, 148 (2005) (acknowledging Hansmann's contribution and confessing uncertainty about the application of intergenerational equity, but not engaging Hansmann's analysis directly); Geoffrey Woglom, *Endowment Spending Rates, Intergenerational Equity and the Sources of Capital Gains*, 22 ECON. EDUC. REV. 591 (2003) (explaining the concept of intergenerational equity in the context of endowment spending without citing Hansmann's critique).

34. See Appendix B for a more detailed account of elite universities' budgetary responses to the loss in endowment value.

35. *See, e.g.*, Eric Messinger, *University Budget Announced*, STAN. DAILY, May 29, 2009, http://www.stanforddaily.com/2009/05/29/university-budget-announced.

function, in the words of Nobel Prize-winning economist Robert Merton, to "hedg[e] against unanticipated changes" in the university's alternative funding sources: tuition, government funding, licensing fees, and current donations.[36] Thus, when external financial turmoil threatens the stability of a university's alternative funding sources, it can turn to its endowment to help mitigate that instability.[37]

To make better sense of the endowment as a rainy day fund, it is helpful to develop the analogy more fully. Presumably, an individual saves money in a rainy day fund in case some emergency—say a prolonged battle with cancer, the unexpected need to care for an elderly parent, or the loss of employment—requires more money than that individual's regular income could support. In other words, although the individual knows that there may come a day when the "rain" will come, she has no sense of when, precisely, that day might arrive. If the day does arrive, the prudent saver has an adequate cushion to substantially cover those expenses. In an ideal situation where the individual has saved sufficiently to cover the emergency's demands, the rainy day will come, the fund will be depleted to the point of covering those demands, and the individual will survive, financially, to fight another day.

If the analogy works, then universities have accumulated endowments precisely in order to weather the kinds of storms that the "once in a century" financial crisis could offer.[38] Universities accumulated excess capital during times of plenty in anticipation of a rainy day. If either the expenses associated with that emergency were sufficiently less than the funds accumulated, or the university's expected income were suddenly less, then the university could dip into those funds to help weather the storm, limited only by some of the legal and financial factors identified below.

To be sure, the elite universities studied in this Note have, in each instance, done precisely that. In each case, the universities paid out from their endowments, even though the endowments lost money in the previous year. Thus, every endowment dollar spent was necessarily a dollar spent from its excess reserves, rather than from its appreciated income. Universities may argue that such spending vindicates the rainy day argument completely.

This argument fails, though, for several reasons. First of all, as explained in Part II, these universities spent only from very recently added excess reserves—while universities did spend portions of their endowments during a year of significant depreciation, the recent history suggests that their

36. Merton, *supra* note 25, at 212.

37. See Raymond Fisman & R. Glenn Hubbard, *The Role of Nonprofit Endowments*, *in* THE GOVERNANCE OF NOT-FOR-PROFIT ORGANIZATIONS 217, 217-18 (Edward L. Glaeser ed., 2003), for a defense of one variation of this argument, which they define as the need to engage in "production smoothing" to "protect against adverse revenue shocks."

38. *See* Peter S. Goodman, *The Reckoning: Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 8, 2008, at A1 (quoting former Federal Reserve Chairman Alan Greenspan).

endowment levels are still at historic highs. Second, the question isn't whether universities tapped their endowments at all—the question is why universities did not tap their endowments *even more*. Returning to the analogy of the individual, it is conceivable that an individual would simultaneously cut her own budget while dipping into savings in order to weather a financial storm. But would this make rational sense if that individual is still a billionaire? That is, if elite universities *could* completely maintain their budgets at the levels of previous years, why was it necessary to make cuts at all? In the words of Senator Grassley in January 2009, "[i]f an endowment is a rainy day fund, it's pouring."[39] Universities' recent behavior seems to collide with that justification.

There are other reasons why universities may have endowments.[40] All essentially lead to this conclusion: the endowment is to function as a buffer to guarantee a stream of payments to assist the university in times of crisis. Those times of crisis have arrived, and yet these universities do not appear to use their endowments for those purposes. Again, either the justifications themselves are misplaced, or there are other forces at play. As we will see below, both are likely correct.

II. UNIVERSITIES AS "DRUNKEN SAILORS"?

Many prominent commentators have assumed that the loss of so much of elite universities' endowments has all but required universities to make significant cuts. Merton contends that it's a "fact that the universities are now poor . . . . If they're going to be poor, they are going to make [budgetary] changes as a result."[41] This conclusion, however, is illogical without more information: it does not follow that even a 40% loss of endowment funds equates to the impoverishment of a university. Other data is necessary to make this kind of conclusion, including operational demands on the endowment and the absolute size of the remaining 60%. By any conventional sense, an institution with several billion dollars in investments *after* the crisis cannot, without more explanation, be considered poor.

A. *Universities Spent Too Little, Not Too Much*

The fact that universities have seen their endowment values increase so dramatically during the past ten years also makes their reaction to endowment

39. Memorandum from Senator Chuck Grassley to Reporters & Editors (Jan. 26, 2009), *available at* http://finance.senate.gov/newsroom/ranking/release/?id=40e86d8b-8c5f-4cad-9aa0-8bbc73b9411b.

40. See Hansmann, *supra* note 23, for a fuller explanation.

41. Gillian Wee, *Endowment Losses from Harvard to Yale Force Cuts*, BLOOMBERG (July 22, 2009), http://www.bloomberg.com/apps/news?pid=20601109&sid=aQn_Cxyu99xY.

loss less obviously necessary. For the five largest universities, the magnitude of wealth represented by an estimated 30% drop in endowment value for fiscal year 2009[42] belies the reality that universities experienced unprecedented growth in endowment value during the previous decade. Assuming that these top five universities lost 30% of their endowment value in fiscal year 2009, their endowments would be valued roughly as indicated in Table A-1. Note that in those figures, the 30% losses to endowment values take the endowments back to their values between 2005 and 2006. The loss in value only accounted for the gains accrued in the last three years. Thus, the expectation that universities must make dramatic cuts in order to stave off unprecedented poverty does not square with the fact that universities only recently gained the wealth lost in the first place.

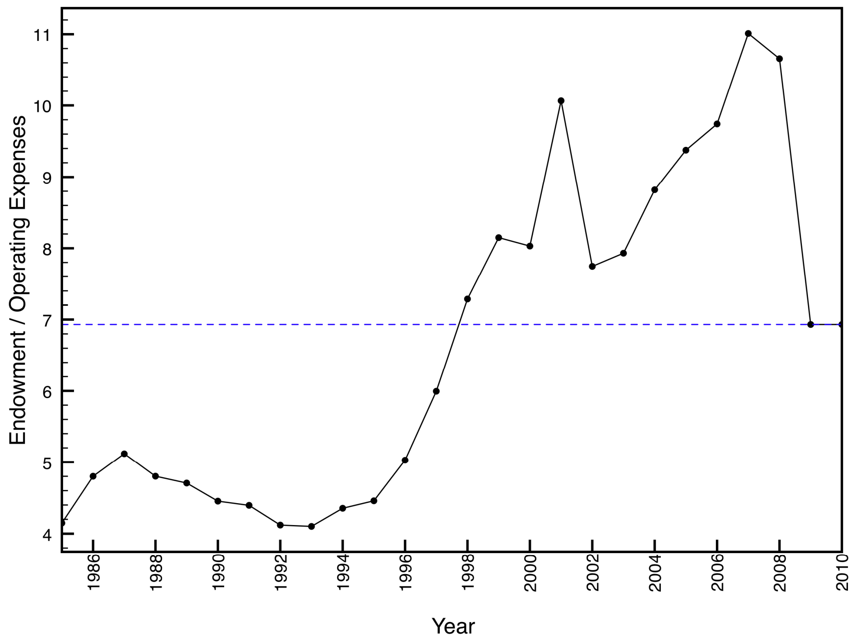
The most appropriate benchmark, however, may not be the absolute size of the endowment, but instead what universities have done with the expectation that endowments would continue to grow. Some have acknowledged how recently universities have gained this wealth, but argue that, during those boom times, universities were "spending like drunken sailors," committing themselves to building projects and scholarship programs that they could not sustain.[43] The data tells a different story. Figure 1 shows the changing value of the ratio of endowment to budget, from 1985 to 2010 (projected).[44]

42. Estimates abound for 2009 losses. *See* John Hechinger & Craig Karmin, *Harvard Hit by Loss as Crisis Spreads to Colleges*, WALL ST. J., Dec. 4, 2008, at A1.

43. Mark Egan, *Book Says Many U.S. Universities Are Waste of Money*, REUTERS (July 30, 2010), http://www.reuters.com/article/idUSTRE66S5I420100730 (quoting Andrew Hacker, who insists that "[tuition] got to where [it is] because both universities and administrators spent like drunken sailors"); David Snowball, *David Snowball's New-Fund Page for October 2009*, FUNDALARM (Oct. 2009), http://www.fundalarm.com/arc0809.htm ("Harvard spent an enormous amount of money. Faced with a seemingly-endless torrent of money, the university went on a spending spree worthy of an entire shipload of drunken sailors on shore leave.").

44. The absolute changes in endowment and budget values are even more stark. Of course, since the drunken sailor story describes a world where the university's budget consumes either a constant or ever-increasing amount of the endowment, describing changes in absolute value is less helpful.

FIGURE 1



The dotted line connects the estimated ratio in 2010—when the budget is projected by Harvard's administration to be roughly 5% less, and the endowment is conservatively estimated to be stagnant.[45] Note that the last time that Harvard experienced this ratio was between 1997 and 1998—at the height of the tech boom. In 1985—arguably the year that Harvard, Yale, and other elite universities began their aggressive investment strategies—the ratio of Harvard's endowment to its budget was 4.15. In the subsequent twenty-five years, that ratio grew to a high of 11.01 in 2007, and a low of 4.10 in 1993.

45. The 5% budget cut is slightly less than the projected cuts require. Harvard must trim $220 million from its budget in order to close its deficit. *See* Tracy Jan, *Harvard Classrooms, Labs Feel Pinch of Budget Cuts*, BOS. GLOBE, June 17, 2009, at A1. The budget for operating expenses for fiscal year 2009—the budget that needed trimming—was $3.756 billion. *See* HARVARD UNIV., HARVARD UNIVERSITY FINANCIAL REPORT FISCAL YEAR 2009, at 4 (2009), *available at* http://vpf-web.harvard.edu/annualfinancial/pdfs/2009fullreport.pdf. More data has become available since the initial drafting of this Note. *See supra* note 21. However, the Note attempts to address the mindset of university administrators at the time of the crisis itself. While data released after the worst of the crisis had passed is helpful to check the validity of these arguments, such data is not helpful in making the argument that universities behaved in unnecessary ways. Such arguments would engage, with the benefit of hindsight, in an exercise that inappropriately stacks the deck in their favor. Thus, I have analyzed only the data available to the university administrators at the time of their budgetary decisionmaking.

Following its losses in 2008, the ratio stood at 6.93. Assuming, conservatively, that Harvard's endowment yields no return in 2010,[46] and that the university makes its announced budget cuts, that ratio will be at 7.30. For the drunken sailor story to make analytical sense, those ratios should have progressed very differently. During times of robust endowment returns, the drunken sailor logic would suggest that that ratio would either stay flat, or move in the opposite direction—that is, that despite a growing endowment, the budget would grow even faster. At the very least, a university overspending during times of plenty would have seen a dramatic drop in that ratio after the crisis stabilized in the winter of 2009. Such is not the case for Harvard—its ratio in 2009 was the same as in the heyday of the tech boom in 1998.

Even more strikingly, Harvard's payout rates during this period of 1999-2006 remained, on average, a steady 4.4%, an average of roughly 6% less than endowment growth.[47] Far from spending like drunken sailors, universities were, if anything, not spending enough—over the past twenty-five years, the endowment-expense ratio has continued to grow.[48] While others profess that such conservative payout rates are only vindicated by today's financial climate,[49] the idea that universities have overspent during years of prosperity, and hence must compensate with significant budget cuts, does not pass muster with the relevant data, at least in Harvard's case.[50]

An additional argument may be made that the operating budget does not represent the full spectrum of spending commitments assumed by universities in these period. For example, universities may have spent a great deal of money on capital and building expansions to be funded by anticipated endowment growth. In that case, the ratio of endowment to operating budget does not tell the story with sufficient detail to analyze consequent decisions to restructure operating budgets.

This argument is difficult to assess, however. University financial statements refer, tangentially, to capital expenses. But they do not identify the source of such funding, which can frequently be restricted gifts, or money raised for those specific purposes. Furthermore, if outsized capital expenditures

46. Given the growth in the economy, a stagnant endowment in 2010 would be a shock.

47. NAT'L ASS'N OF COLL. & UNIV. BUS. OFFICERS, 2008 NACUBO ENDOWMENT STUDY 192 tbl.50, 246 tbl.54 [hereinafter NACUBO 2008]; *see also infra* Table A-2.

48. Gary Becker, another Nobel Prize-winning economist who has weighed in on the issue, agrees with this assessment, at least in principle. He argues that universities' endowment spending patterns are "flawed," and that universities have "reduced their spending by too much" based on their history of underspending their endowment returns. Gary Becker, *How Should Universities React to the Decline in Their Endowments?*, THE BECKER-POSNER BLOG (July 19, 2009, 2:53 PM), http://www.becker-posner-blog.com.

49. *See* Kaminski, *supra* note 18 (quoting Yale President Richard Levin).

50. Although full-blown data analysis would be required to determine whether other elite universities are situated as is Harvard, there is no analytical reason why Harvard would be different than the others in this respect.

account for the university's inability to liquidate more of their endowments during a financial crisis, then universities must be explicit on that front. Instead, universities have almost been uniform in their identification of the financial crisis and losses to endowment reserves as the source of their budgetary restructuring. On the evidence available, this argument is difficult to sustain.

Given the reality, then, that neither theory nor recent history suggests that universities are especially "poor," to use Merton's blunt term, universities have entered a largely destabilizing period where they have made dramatic cuts to their operating budgets in order to protect university finances even though their endowments still retain significant value. Some other factor or factors must explain why universities cannot—or do not—make use of their reserved capital to weather these financial storms.

B. *How Much Is Too Much?*

A discussion of the ratio between endowments and budgets raises an intriguing and, as yet, underexplored question—how high is too high? At what point do endowments become larger than any possible benefit could justify? This question has been posed throughout history: the famed French economist Anne Robert Turgot argued in eighteenth-century France that the Catholic Church's accumulation of the functional equivalent of endowed funds represented an affront to the natural law, and that governments retained the right to lay claim on excessive endowments.[51] In other contexts, the law explicitly discourages the accumulation of such excess income: corporations face an "accumulated earnings" tax on savings "deemed to be unreasonable and in excess of what is considered ordinary."[52] And other nonprofits—universities and their endowments excepted—face an obligatory 5% payout rate.[53] Although the question of whether, in general, universities should be tax exempt has been thoroughly debated,[54] the question of how much is too much for university endowments is still in the early stages of empirical and theoretical analysis.

Those scholars who have broached the issue have come to different conclusions for different theoretical reasons. Much of this literature focuses on

51. *See* Jack A. Clarke, *Turgot's Critique of Perpetual Endowments*, 3 FRENCH HIST. STUD. 495, 498-99 (1964).

52. *Accumulated Earnings Tax Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/a/accumulatedearningstax.asp (last visited Nov. 16, 2010); *see also* 26 U.S.C. §§ 531-537 (2006).

53. 26 U.S.C. § 4942(e)(1).

54. *See* Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299 (1976); John D. Colombo, *Why Is Harvard Tax-Exempt? (and Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841 (1993); Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54 (1981).

the potential agency costs that excessive endowments can create, a topic to which we will return in Part V. Fisman and Hubbard cite an unnamed source from the National Center for Nonprofit Boards that specifically recommends that nonprofits not carry more than two years' worth of operating expenses.[55] Core et al. find that nonprofits—including universities—with larger endowments "do not exhibit higher growth in program expenses or investments" and that "excess CEO pay and total officer and director pay are greater for firms with excess endowments."[56] And yet, defining how much is too much remains elusive.

This question becomes even more provocative for elite universities. For example, while Yale tracked Harvard's endowment-expense ratio throughout the 1990s and 2000s, Stanford—the third largest endowment in the country in absolute size—has had an endowment-expense ratio of between two and four. Princeton, by stark contrast, consistently maintains a double-digit endowment-expense ratio.[57] For obvious reasons, when comparing the spending and saving behaviors of universities, a difference in endowment-expense ratios—what Fisman and Hubbard call "endowment intensity"[58]—can have significant explanatory value in describing why some universities react differently than others in the midst of financial crisis. Nevertheless, it could also be plausible that, objectively, an endowment-expense ratio of two is, itself, "excessive," and that a Princeton-level ratio is hyperexcessive. Discerning that meaning would require a more rigorous theoretical and empirical development than is undertaken here. Even so, the variation in these ratios among the elite universities is indicative of greater attention due to this underexplored area.

Regardless of whether an objective standard for excessive endowments can be reached empirically, this Note answers unequivocally one question: the idea that the university has had to cut its budgets due to overeager budgetary expansions is wholly inconsistent with the university's own financial data. The drunken sailor story is, therefore, not a viable explanation for recent university behavior. While more empirical analysis for other universities is needed, those who argue that universities have overspent and are now too poor to be expected to maintain their previous spending levels must show why this is the case.

III. THE LAW OF UNIVERSITY ENDOWMENTS

The legal framework that governs university endowments has been blamed—rightly and wrongly—for having an outsized influence on how

55. Fisman & Hubbard, *supra* note 37, at 227.

56. John E. Core et al., *Agency Problems of Excess Endowment Holdings in Not-for-Profit Firms*, 41 J. ACCT. & ECON. 307, 331 (2006).

57. See Appendix B for more data on Princeton's endowment; for detailed data on Princeton's finances, see *Report of the Treasurer*, PRINCETON UNIV., http://finance.princeton.edu/princeton-financial-overv/report-of-the-treasurer (last updated Feb. 23, 2011).

58. Fisman & Hubbard, *supra* note 37, at 225.

universities administer and invest their endowment funds.[59] This Part analyzes how the law governing university endowments strongly influenced university endowments' poor performance through 1975, and how changes in the law—and corresponding endowment growth—after that time have made the law's influence on elite endowments much less pronounced. The two main restrictions that the law continues to place on university endowments—the need to honor donor intent on restricted gifts, and the prohibition against spending the historic dollar value of the endowment—may continue to have a significant effect on younger, smaller endowments. But these laws do not restrict the elite, older endowments in the same way.[60] The law therefore offers no meaningful restriction on elite universities' spending, and accordingly cannot explain these universities' reactions to the financial crisis.

A. *The Development of Law and University Endowments: Trustees, Corporations, and UMIFA*

The law governing charitable trusts and corporations has developed "in a piecemeal manner."[61] Courts have looked to trust law, historically, to determine the rights and responsibilities of those who manage these funds, even as more and more charities have made the switch in organizational form from trusts to nonprofit corporations. Charities have therefore come to fill a gap between trusts and corporations—some look like corporations, others more like trusts, and still others like something different altogether. The consequence has been that "[t]he laws that have developed for charitable organizations do not always work well, in part because" the regulation of charities does not fit well within the rules governing private trusts or for-profit business.[62]

In part because of this jurisprudential confusion, historically it had been difficult to know the duties that managers of institutional funds had to those funds and the institutions which owned them. Initially, the law took a hard-line

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59. *See* John Hechinger & Jennifer Levitz, *Battered Nonprofits Seek to Tap Nest Eggs*, WALL ST. J., Feb. 11, 2009, at A5; Oliver Staley, *Endowments Trapped by Losses at NYU Expose Dated Laws*, SAN DIEGO SOURCE, July 28, 2009, http://www.sddt.com/News/article.cfm?SourceCode=20090728fy; Richard Posner, *The Drop in University Endowments and What to Do About It*, THE BECKER-POSNER BLOG (July 19, 2009, 3:04 PM), http://www.becker-posner-blog.com/2009/07/the-drop-in-university-endowments-and-what-to-do-about-it--posner.html.

60. It is difficult to know for sure without analyzing the donor instruments themselves. A dogged scholar would need to get university and donor permission in order to view them. Given the sensitivity of these issues for universities and donors, such analysis is unlikely to occur.

61. Susan N. Gary, *Charities, Endowments, and Donor Intent: The Uniform Prudent Management of Institutional Funds Act*, 41 GA. L. REV. 1277, 1281 (2007). Gary is the Reporter for the Drafting Committee charged with the revision of the 1972 Uniform Management of Institutional Funds Act.

62. *See* Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 595 (1999).

trust law approach to investment management and did not look kindly on trustees' perceived investment misadventures. In 1830, the Massachusetts Supreme Judicial Court issued a famous ruling in *Harvard College v. Amory*, calling for a prudent man rule, under which a trustee faced liability if he chose investments that, in a court's view with hindsight, the trustee would not have chosen for himself.[63] Consequently, trustees tended to invest far more for safety than for growth, a practice that extended through the 1960s. The influential *Restatement (Second) of Trusts* encouraged—arguably required—a trustee to make investments "with a view to the safety of the principal and to the securing of an income reasonable in amount and payable with regularity."[64] Some states even published lists of appropriate investments, restricted to "government securities, first mortgages on land, and certain types of bonds."[65]

The problem with the *Restatement*/*Harvard College* prudent man rule was that such an investment strategy was frequently counterproductive. Investing strategies that focused on the safety-and-preservation approach frequently meant returns on assets that were less than inflation, resulting in the real erosion of endowment value.[66] This was particularly true from the 1950s to the 1970s, when inflation rose, bond values fell, and equities increased.[67] As a result of this view, universities presided over significant real loss in endowment value as inflation eroded endowments faster than conservative investment strategies could increase them. Trust law's mandatory conservatism was taking its toll on charities, including universities, during this period.

From an investment standpoint, the reign of trust law over endowment management had two concrete problems: the definition of income and the definition of risk. For income, trust law had long held that trustees could only spend income, not principal, on behalf of the beneficiary.[68] This much was uncontroversial, and remains largely true today. More problematically, trust law took a narrow view of income, limiting it to "interest and dividends but not capital gains."[69] Any equity component of an investment, by definition, remained untouchable by the beneficiary institution. Given the long-term benefits of equity ownership,[70] this definition precluded universities from

63. 26 Mass. (9 Pick.) 446, 469 (1830).

64. *See* RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. e (1959).

65. *See* Gary, *supra* note 61, at 1283 n.25 (quoting RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. p (1959)).

66. *Id.* at 1284.

67. *Id.*; *see also* WILLIAM L. CARY & CRAIG B. BRIGHT, THE DEVELOPING LAW OF ENDOWMENT FUNDS: THE "LAW AND THE LORE" REVISITED 8 (1974); SEYMOUR E. HARRIS, HIGHER EDUCATION: RESOURCES AND FINANCE 424 (1962).

68. Gary, *supra* note 61, at 1283.

69. *See id.*

70. See JEREMY J. SIEGEL, STOCKS FOR THE LONG RUN 3-6 (2d ed. 1998), for an accessible analysis of the historical benefits of equity over debt investing.

making investments that would ultimately have benefited such institutions with long-term investment horizons.

This conservatism started to change in 1969. As a consequence of the murky legal obligations facing managers of institutional funds, and the very real depreciation of endowment wealth that occurred during the 1950s and 1960s, the Ford Foundation commissioned a study by William L. Cary and Craig B. Bright.[71] Cary and Bright concluded that the confusion surrounding the duties of endowment fund managers—including unclear liability for speculative losses, for example—resulted in this kind of conservative investing strategy that eroded universities' real returns.[72]

The Cary and Bright study represents a watershed in the history of endowment law. The study surveyed the landscape of nonprofit law, primarily through legal analysis of court decisions, and concluded that "[t]he law relating to charitable corporations in general, and particularly to the administration of endowment funds, remains throughout the nation both 'rudimentary and vague.'"[73] After thoroughly analyzing the legal treatment of endowed funds, Cary and Bright concluded that, to the extent that managers of endowed funds felt limited in their investment options, "the fault [could not] fairly be said to lie in the law. Legal impediments which have been thought to deprive managers of their freedom of action appear on analysis to be more legendary than real."[74] That legal conclusion notwithstanding, the authors did advocate for legislative action to make explicit what a thorough review of the common law already suggested: that there was no restriction on spending the "realized gains of endowment funds."[75]

Following the recommendations in Cary and Bright's study, the Uniform Law Commission drafted the Uniform Management of Institutional Funds Act (UMIFA) in 1972,[76] which was quickly adopted in forty-seven states and the District of Columbia.[77] UMIFA accomplished two things: (1) it allowed managers of university endowments to define the "income" from university endowments more liberally, such that capital gains could be included in the income invested on the trust's behalf, and (2) it liberated the kinds of investments that university managers could pursue. In the process, universities

71. WILLIAM L. CARY & CRAIG B. BRIGHT, THE LAW AND THE LORE OF ENDOWMENT FUNDS: REPORT TO THE FORD FOUNDATION (1969).

72. *Id.* at 5.

73. *Id.* at 14 (citation omitted).

74. *Id.* at 66.

75. *Id.*

76. *See* John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 642, 646-49, 652 (1996).

77. James K. Hasson, Jr. & Matthew J. Gries, *UPMIFA and Private Foundations*, SUTHERLAND, http://www.sutherland.com (search keywords "UPMIFA and Private Foundations"; then select "UPMIFA and Private Foundations" hyperlink) (last visited Feb. 2, 2011).

started shifting their asset portfolios toward greater diversification, largely in stocks, bonds, and cash.[78]

UMIFA maintains restrictions on endowment spending in significant ways. As a corollary to its redefinition of income, UMIFA made explicit that universities could not spend "historic dollar value" (HDV), or the original value of the gift, not adjusted for inflation.[79] Thus, if the value of the gift ever declined to less than the value of the original gift—often referred to as "underwater" endowments[80]—then UMIFA would restrict universities from spending that historic dollar value. For example, if a donor provides $100,000 as a perpetual endowment to Stanford, and financial volatility reduces the value of that gift to $80,000, a university cannot spend the original "principal" until that amount has grown again to at least $100,000, even for spending priorities consistent with donor intent. Many press accounts and commentators have addressed this restriction on endowment spending during the current crisis.[81] As the Associated Press reported in March 2009, UMIFA presents "a frustrating quandary for universities . . . . They have the money they need to save jobs [and] offer scholarships . . . , but face state laws that keep them from using any of it."[82] In that sense, it is assumed, the law restricts universities in their spending, creating avoidable budget crises simply because available endowment funds cannot be tapped.

B. *UMIFA, UPMIFA, and the Financial Crisis*

If, as that account describes it, UMIFA restricts access to elite universities' endowments, then the explanation for severe budget disruption is apparent. But there are three problems with this argument, as applied to elite universities.

First, and most significantly, UMIFA no longer applies to the four states—California (Stanford), Connecticut (Yale), Massachusetts (Harvard and MIT), and New Jersey (Princeton)—that host the universities studied in this Note. Its successor law, the Uniform Prudent Management of Institutional Funds Act (UPMIFA), eliminates the concept of historic dollar value and allows universities to spend underwater endowments without violating the law. UPMIFA still places restrictions on the amount that universities can spend of the gift's original value, but those restrictions are standards rather than bright-line rules, such as the consideration of "the duration and preservation of the

78. *See id.* (describing how Modern Portfolio Theory and the value of diversification influenced the development of trust management laws).

79. Susan Gary, *UMIFA Becomes UPMIFA*, 21 PROP. & PROB. 32 (2007), *available at* http://www.nccusl.org/Update/Docs/UMIFA%20Becomes%20UPMIFA.pdf.

80. *Trust Funds: Practices for Underwater Endowments*, U. WIS., http://www.wisconsin.edu/tfunds/underwaterendowprac.htm (last visited Feb. 3, 2011).

81. *See, e.g.*, Martha Waggoner, *Some Nonprofits Can't Touch Their Money*, MSNBC.COM (Mar. 1, 2009), http://www.msnbc.msn.com/id/29454579/ns/us_news-giving.

82. *Id.*

endowment fund" and "general economic conditions."[83] But even then, these universities can spend their endowments with far greater liberty than was previously the case. Thus, since the elite universities studied here are not restricted by UMIFA, the ban against spending funds that fall below historic dollar value does not apply.

Of course, the last of the states relevant to this study (Massachusetts) adopted UPMIFA in the summer of 2009, already after the bulk of endowments' depreciation. Thus, perhaps the explanation is that UMIFA bound the schools throughout the crisis; UPMIFA's innovations were therefore irrelevant. If that is the case, it raises an interesting question about the universities' incentives in seeking the changes that UPMIFA offered. UPMIFA's relaxed spending rules had been debated since endowment values had last tanked following the bursting of the Internet stock bubble in 2000-2001, and were released for state ratification in 2006.[84] If these universities could not access their endowments simply because of UMIFA's heavy restrictions, as the Associated Press report indicates, then they could have agitated for rapid enactment of UPMIFA's more relaxed standards and thereby avoided making cuts to their operating budgets. Interestingly, Harvard did "not acknowledge[] any familiarity with the legislation" when UPMIFA was before the Massachusetts legislature.[85] Such a lack of familiarity with legislation that could, ostensibly, open the doors to millions of dollars of necessary spending money for the university invites the inference that the changes in UPMIFA simply were not as relevant for Harvard as they were for other universities.

This suggested lack of UPMIFA's relevance is confirmed by the second reason that UMIFA does not meaningfully restrict elite universities in their endowment spending: neither UMIFA nor UPMIFA covers all of the funds popularly construed as the university's "endowment." Although, in the popular sense, a university's endowment refers to all capital reserves, the legal definition is quite different. UMIFA defines an endowment fund as "an institutional fund, or any part thereof, not wholly expendable by the institution

83. UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT (UPMIFA) § 4(a)(1), (3), 7A U.L.A. pt. 3, at 17 (Supp. 2008). UPMIFA also creates an optional provision adopted by some states, including Massachusetts, that creates a rebuttable presumption that spending more than 7% of the endowment is "imprudent." That presumption could explain universities' behavior, except that (1) UPMIFA had not been adopted when most of these decisions were made, and (2) the presumption could be rebutted by the extraordinary circumstances of the times. While the seven percent rule, then, could limit spending for those endowed funds, universities could fight against that limitation, should they decide that endowment spending in order to preserve budgetary stability serves the best interests of the university.

84. UNIF. LAW COMM'N, UPMIFA: A SUMMARY (2006), *available at* http://www.nccusl.org/Update/uniformact_summaries/UPMIFA_Summary.pdf.

85. Peter F. Zhu, *Bill May Allow Flexibility*, HARV. CRIMSON, Jan. 28, 2009, http://www.thecrimson.com/article/2009/1/28/bill-may-allow-flexibility-massachusetts-lawmakers.

on a current basis under the terms of the applicable gift instrument."[86] In other words, a gift from a university admirer does not immediately constitute an endowment. In order to become part of the endowment, it must be the donor's explicit intent to restrict the use of the gift not only to a specific purpose, but also to a specific period of time, usually in perpetuity. UPMIFA, for example, explicitly adds the clarifying clause that the term endowment "does not include assets that an institution designates as an endowment fund for its own use."[87] Thus, while Harvard's 2008 "endowment" was reportedly $36 billion, not all of this amount is governed by UMIFA/UPMIFA.

For example, Harvard's financial reports indicate that only 12.5% of its endowment is permanently restricted, almost 17% is fully unrestricted, with the remaining 71% in an opaque category of "temporarily restricted."[88] It is unclear whether these temporary restrictions would bring those funds under the application of UMIFA/UPMIFA. Other sources have estimated that the largest private university endowments have only 55% of their endowments, in the popular sense, restricted by the original donor instruments.[89] Any claim that the law restricts the spending of the endowment in the popular sense—as it is used in this Note, to refer to the university's entire reserved capital—misses the fact that UMIFA does not apply to at least half of those funds. For that half, the university is free to spend—and save—as it pleases, with no legal obligation in any direction. Thus, any claim that UMIFA/UPMIFA restricts spending will only apply to the 55% of reserved capital that these laws govern.

Third, even if UMIFA did apply to these schools, and even if that restricted amount covered the bulk of available funds, it is not clear that the majority of elite universities' funds are underwater at all. As noted above, the growth from universities' endowments over the last several decades has been remarkable.[90] As the data represents for Harvard, an endowment fund would only be "underwater" if the funds were received in or after 2005 or 2006. In those cases, Harvard has an argument that it is restricted from spending principal for those endowed funds. But by Harvard's own report, total gifts from 2004 through 2008 equaled roughly $3 billion, much of which may have been donated for "current use."[91] Even assuming that all $3 billion is underwater, and governed by UMIFA/UPMIFA, that relatively small amount cannot explain the need to cut budgets as Harvard has done. These elite universities have had the advantage of a long and storied history of successful fundraising and investment returns, creating an income cushion that could protect the

86. UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT (UMIFA) § 1(3), 7A U.L.A. pt. 3, at 12 (2006).

87. UPMIFA § 2(2), 7A U.L.A. pt. 3, at 9 (Supp. 2008).

88. HARVARD UNIV., HARVARD UNIVERSITY FINANCIAL REPORT FISCAL YEAR 2008, at 16 (2008), *available at* http://vpf-web.harvard.edu/annualfinancial/pdfs/2008fullreport.pdf.

89. NACUBO 2008, *supra* note 47, at 43 tbl.33.

90. *See supra* Part I.B.

91. HARVARD UNIV., *supra* note 88, at 4, 5.

university's spending in times of crisis. Consequently, the endowment-eroding consequences of the financial crisis simply do not affect elite universities in the same way they might affect, say, a thinly or recently endowed museum or university.

Thus, because (1) UMIFA's stricter limits on university spending no longer apply to these elite universities, (2) UMIFA only applies to roughly half of the funds designated by the university as the "endowment," and (3) elite university endowments have grown significantly in recent decades, there is reason to doubt whether UMIFA/UPMIFA are as restrictive to elite university spending habits as they might be to other entities. A more thorough analysis of the data for all of the elite schools studied here is required before drawing a firm conclusion, to be sure. The data reported, though, is sufficient to challenge this frequently recited justification for university behavior.

C. *Charitable Trusts and (the Illusion of) Donor Restrictions*

A related legal restriction on endowment spending comes from the specific donor instrument itself. The law of charitable trusts requires that donor restrictions must be honored.[92] If one gives money to Stanford University exclusively for the humanitarian elimination of the university's squirrels, for example, and Stanford accepts the gift, then the university may not use that gift for any other purpose. If Stanford violates that trust, the state attorney general—or, in rare cases, representatives of the original donor's estate[93]—may sue Stanford to adhere more closely to the terms of the gift instrument.[94] Many have argued that these kinds of restrictions keep universities from spending their endowments as liberally as they would like, and that those who think of an endowment as one giant pot of money ready for general university disposition have badly misconceived the endowment's actual purpose.[95] While it is true that a single endowment often represents hundreds or thousands of individual accounts—Harvard's endowment, for example, comprises approximately 11,600 accounts[96]—it is not at all true that all of the universities' funds are restricted by the terms of these endowed gifts in any meaningful sense. This is

92. *See* Gary, *supra* note 61, at 1311.

93. Original donors usually lack standing to enforce the terms of their donation. The exception is when the donors retain a reversionary interest in the donation. *See* Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 445-49 (1960) (collecting cases that establish that "neither the settlor of a charitable trust nor his successors may sue to enforce the trust"); *see also* Iris Goodwin, *Ask Not What Your Charity Can Do for You:* Robertson v. Princeton *Provides Liberal-Democratic Insights into the Dilemma of Cy Pres Reform*, 51 ARIZ. L. REV. 75, 93 (2009).

94. *See* Gary, *supra* note 61, at 1325-26.

95. *See* DAVID F. SWENSEN, PIONEERING PORTFOLIO MANAGEMENT 9-23 (2009); Dana G. Mead & Jeremy M. Jacobs, Op-Ed., *Don't Require Colleges to Spend More of Their Endowments*, CHRON. HIGHER EDUC. (D.C.), Nov. 9, 2007, at 20.

96. HARVARD UNIV., *supra* note 45, at 33.

the case for two reasons: (1) only a slim majority of endowment funds typically have any kind of restriction at all; and (2) even those funds that are restricted can, to some extent, be positioned for flexible use.

In describing the consequences of donor restrictions on university spending behavior, I sidestep the fascinating—and very old—debate about whether the law should honor these restrictions in the first place.[97] The line of critics of the law's reverence for the "dead hand" in charitable gifts is long and illustrious: the eighteenth-century French economist Anne Robert Turgot,[98] the eighteenth-century French philosopher Montesquieu,[99] the nineteenth-century English common law judge Lord Campbell,[100] and the English philosopher John Stuart Mill[101] have all roundly criticized the practice of giving credence to benefactors long dead. More recently, Sarah Waldeck has called for a compromise to the pre-financial crisis endowment debate by limiting the force of donor restrictions to twenty-five years.[102] As interesting as these arguments are, my point here is to take universities at their word and analyze how the law would *actually* present a limit on university spending choices, not whether the law *should* present those limitations. And for elite universities, the fact that the law honors the wishes of those long dead may be of almost no consequence to the actual spending habits of universities.

First, as noted above, these restrictions simply do not apply to the entire endowment. The largest endowments have only between 50% and 60% of their funds restricted in any way.[103] That leaves at least an additional 40% of their endowments open for any use which the university deems necessary. Thus, while a majority of the endowment is restricted, it is a slim majority. Much of a university's endowment can be used for whatever purpose the university wishes.

Second, even assuming that university endowments are restricted, it is unclear what these restrictions even mean for universities' behavior. Many of these "restrictions" require a university to spend the gift on "student aid," for example.[104] When half of the gifts that universities receive are restricted to cover most of the universities' operating budget, it is difficult as an interpretive matter to deem these gifts really "restrictive" to the universities. Additionally, even when the restrictions are in place, universities can be quite flexible in their interpretation. For example, a Yale donor and railway engineer gave money in

97. See Austin Wakeman Scott, *Education and the Dead Hand*, 34 HARV. L. REV. 1 (1920), for an excellent summary and discussion of this debate.

98. Clarke, *supra* note 51, at 498.

99. *Id.* at 495.

100. Scott, *supra* note 97, at 2.

101. *Id.* at 13-14.

102. Waldeck, *supra* note 19, at 1819, 1821-22.

103. Calculations based on NACUBO 2008, *supra* note 47, at 43 tbl.33.

104. *See* Karen W. Arenson, *When Strings Are Attached, Quirky Gifts Can Limit Universities*, N.Y. TIMES, Apr. 13, 2008, at A18.

1923 to endow a professorship for the study of railway safety, "in particular the work in connection with the development and improvement of designs of rails, roadbeds and crossties."[105] Railway safety, though no doubt still important, occupies a less central place in today's universities. Yale's administration thus creatively uses the gift to fund Professor A. Stephen Morse, an electrical engineer who studies, among other things, system theory, urban transportation and the "coordination and control of large grouping [sic] of mobile autonomous agents," whatever that means.[106] While Morse's work is undoubtedly of great value to the university and the academy, it is hardly work at the core of research into improving designs of rails, roadbeds, and crossties. Similarly, a Dartmouth donor gave money in 1945 to provide firewood for the president's office. Today, that money is used for the office's general expenses.[107] While some very specific gifts—such as a funded scholarship exclusively for a student from a specific small town—are more difficult to modify or interpret liberally, others impose little to no restriction at all.

This flexible attitude toward donor restrictions is far from new. The story of the New World's first endowed professorship—the Hollis Professorship of Divinity at Harvard, endowed in 1721—provides a fascinating example of the perversion of donor intent from deep in the history of American higher education.[108] Thomas Hollis, a merchant of London and a Baptist, was convinced by Harvard's President John Leverett, to endow a chair in divinity. This probably came as something of a surprise to Hollis: as a Baptist, Hollis believed in the practice of adult baptism, and indeed, that infant baptism was a sacrilege. Massachusetts's and Harvard's Puritan Congregationalists, who controlled the colony and college, staunchly defended infant baptism,[109] even to the point of religious persecution of those who, like Hollis, disagreed. Nevertheless, the more liberal John Leverett prevailed on Hollis, who endowed the chair on two general conditions: (1) "that none be refused on account of his belief and practice of adult baptism," and (2) that the College select a man "of sound and orthodox principles."[110] It is unclear what, exactly, Hollis meant by "orthodox principles," but the Congregationalists who controlled Harvard understood it to mean something very specific indeed. The trustees of the university required, initially, for an applicant for the chair to "declare[] his faith" in, among other points of doctrine, the "divine right of infant

105. *Id.*

106. *See* A. STEPHEN MORSE, http://www.eng.yale.edu/controls (last visited Feb. 20, 2011).

107. Arenson, *supra* note 104.

108. The account is masterfully retold in Samuel Eliot Morison's treatise on Harvard, SAMUEL ELIOT MORISON, THREE CENTURIES OF HARVARD: 1636-1936, at 66-68 (1936). The summary that follows is drawn exclusively from Morison's authoritative account.

109. *See id.* at 67.

110. *Id.* at 66-67.

baptism."[111] The historical record is unclear whether Hollis knew of this alteration; it is clear, however, that his intent to keep the door to his professorship open regardless of one's position on the question of adult baptism was immediately and summarily repudiated.

Today, such a blatant perversion of donor intent could be attacked in court and, indeed, it is extremely unlikely that elite universities today would seek to undermine a donor so explicitly. In the case of more subtle interpretation of donor intent, though, the question of litigation is a more complex one. To be sure, universities face the risk of litigation if they fail to hew to their donors' intent; the scope and nature of that litigation risk, though, is a thorny and complex question that may not restrict universities in their endowment spending.

D. *Litigation Risks*

Another potential legal limit that universities face regards potential litigation risks. These risks are essentially of two varieties, each discussed in this Subpart. First, universities could be sued for spending endowed funds in ways not contemplated by the terms of the donative instruments. And second, universities could be sued under UPMIFA for spending more than 7% of the "fair market value of an endowment fund" as UPMIFA creates a "rebuttable presumption of imprudence" when spending reaches that level.[112] This Subpart looks at both risks and concludes that in both cases, universities do not face meaningful legal restrictions against spending their endowments in times of financial crisis.

1. *Donor suits: the example of Princeton University*

As documented above, universities frequently bend the terms of donative instruments in ways that significantly liberate the ends to which universities may put the funds in question. However, there is always a risk that donors (or, in most cases, state attorneys general) will sue the university to enforce the original terms of the donation, or even rescind the gift entirely. For reasons that will become clear, this litigation risk is both remote and unlikely to present any significant barrier to universities in their regular endowment expenditures. Princeton University, one of the five universities studied here, recently emerged from one such litigation, and the case in question provides an excellent window both into the litigation risks that universities face, and the extent to which those risks are incapable of explaining university action during a financial crisis.

111. *Id.* at 67.

112. UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT (UPMIFA) § 4(d), 7A U.L.A. pt. 3, at 17 (Supp. 2008).

In 1961, following President John F. Kennedy's admonition to "ask not what your country can do for you—ask what you can do for your country,"[113] the Robertson family, heirs to a shipping fortune, donated roughly $35 million to Princeton to help build its Woodrow Wilson School of International and Public Affairs.[114] The Robertson family donated those funds with the specific restriction that the money be used to "strengthen the government of the United States and increase its ability and determination to defend and extend freedom throughout the world."[115] The family sought to boost the number of Princeton graduates who left the Woodrow Wilson School directly to work in "areas of the Federal Government . . . concerned with international relations."[116]

Soon, however, the family became increasingly agitated and disappointed. Much to the Robertsons' dismay, the majority of graduates went not to the federal government, but to "advanced study, the teaching profession, college administration, private business, journalism, law, medicine, and music."[117] As the decades wore on, the Robertson gift continued to balloon under Princeton's management, and Princeton made use of the funds in ways that the Robertson family eventually challenged as inconsistent with the terms of the donation.[118]

Although Princeton aggressively denied the lawsuit's allegations, and moved unsuccessfully to dismiss the suit, the litigation continued until settlement in December 2008, mere weeks before trial.[119] The terms of the settlement required Princeton to pay the Robertson Foundation's substantial legal fees, and an additional $50 million to allow the Robertsons to launch a new foundation dedicated to improving the caliber of public servants. Princeton then gained control of the rest of the Robertson gift, and can use the fund at its own discretion, providing that the original terms of the donation are honored.[120]

The Robertson case has an alluring charm for the present analysis into university behavior in financial crisis. It is a case where an elite university with a huge endowment is sued over the administration of its funds. Presumably, this

113. President John F. Kennedy, Inaugural Address (Jan. 20, 1961) (transcript available at http://avalon.law.yale.edu/20th_century/kennedy.asp).

114. Goodwin, *supra* note 93, at 83.

115. *Id.* at 85 (citing Defendant's Amended Answer, Affirmative Defenses, & Counterclaims for Declaratory Relief, Nature of Counterclaims, Robertson v. Princeton Univ., No. C-99-02 (N.J. Super. Ct. Ch. Div. dismissed Dec. 12, 2008)). The donation actually established a foundation through which the funds would be spent, exclusively at Princeton, for this purpose. The foundation's board consisted of seven members, three of whom were appointed by the Robertson Family, and four of whom appointed by Princeton. *Id.* at 84.

116. *Id.* at 85.

117. *Id.* at 87.

118. *Id.* at 92 (citing examples of uses that Princeton made of the Robertson funding that the family found inconsistent with the mission).

119. *Id.* at 95.

120. *Id.* at 96 (citing Settlement Agreement at 5, *Robertson*, No. C-99-02).

case presents the specter of litigation to keep universities' spending more closely centered on the donors' original intentions. But as tempting as this narrative is, the Robertson case is almost completely irrelevant to our main question: whether the law restricts universities in financial crisis in the spending of their endowments.

First of all, the Robertson case cannot be seriously described as anything less than a resounding victory for Princeton and a message to all donors who would contemplate suit against a university for failure to adhere to the terms of the donor instrument. Although the university had to spend roughly $100 million—no small amount, even by elite university standards—it is forever rid of a donor relationship that exhibited a significant level of control over the expenditure of university funds.[121] This victory is all the more dramatic given that the Robertson case represented the strongest of positions that a donor could have: the Robertsons had standing to sue, which is rare in these cases, and also had substantially more control over the donation than most donors—even donors of large gifts. If the Robertsons ceded control, given these advantages, a donor of an average endowed fund lacks almost any hope of using litigation as a serious enforcement mechanism. Universities like those described above can continue to liberally interpret the terms of their donor instruments such that railroad money can continue to fund electrical engineers[122] and money for government service can support academic sociologists with no ties to government service.

Second, and more importantly, the Robertson case addresses a fundamentally different question than university spending in a financial crisis. The Robertson case is about universities that stray far afield of the original donor intent. The spending of university endowments during financial crises is about using endowments for their *intended* purposes, but to a greater extent than previously envisioned. In other words, it is not about using football money to fund engineering scholarships; it is about spending much more football money than the university had expected to spend, given the crisis-induced lack of available funding from other sources. To understand the extent to which universities can spend from their endowments under UPMIFA requires a different analysis.

2. *UPMIFA and prudential spending*

As mentioned, UPMIFA establishes a rebuttable presumption that a nonprofit (including a university) that spends more than 7% of its endowment

121. And even after paying the $100 million, the original Robertson gift of $35 million appreciated to $650 million. *See* John Hechsinger & Daniel Golden, *Poisoned Ivy: Fight at Princeton Escalates over Use of a Family's Gift*, WALL ST. J., Feb. 7, 2006, at A1. It is difficult to argue that the litigation costs that Princeton bears represent any kind of real loss to their control over this sizeable gift.

122. *See supra* text accompanying notes 105-06.

principal has acted imprudently.[123] A university that acts contrary to this presumption stands exposed to litigation, most likely from the state attorney general's office, though almost certainly as a consequence of the donor's complaints. There is a plausible logic that suggests that universities like those studied here would be loath to increase their payout rates during a crisis year beyond 7%—who wants to cross swords with a rebuttable presumption, after all, especially when university resources are deemed to be under significant stress?

This answer, though, assumes too much from UPMIFA. Two provisions within the statute provide cover for universities to spend much, much more than they have planned. First, the presumption is rebuttable; a university that seeks to spend beyond the 7% can do so if it provides a good faith reason. And second, the way that UPMIFA calculates the 7% could mean, in Harvard's case, that the university has over $1 billion more at its disposal than the 7% rule would suggest.

UPMIFA allows universities to make payout decisions based on a balance of seven factors. One of these factors is "general economic conditions";[124] that is, if general economic conditions suggest more or fewer payouts are necessary, then universities can adjust accordingly. As universities faced the largest loss to their endowments in a generation, state attorneys general and donor supporters would have had a difficult time sustaining a criticism that general economic conditions during the financial crisis did not permit the universities to use more of their funds than would be allowed under more stable market conditions. The argument that a university acted imprudently by spending more of its endowment to support itself during a crisis flies in the face of the entire conception of the endowment.

The second provision is far more interesting. When universities describe their payout rates, they understandably describe the rate as the result of the payout value divided by the total endowment rate. For example, a payout of $500 million on a $10 billion endowment has a payout rate of 5%, as reported by the university in its annual reports. But UPMIFA does not follow that formula at all. Instead, in determining the 7% payout rate, UPMIFA looks at "the fair market value of an endowment fund, calculated on the basis of market values determined at least quarterly and averaged over a period of not less than three years immediately preceding the year in which the appropriation for expenditure is made."[125] For an endowment like Harvard's, the 2009 payout could not be greater than 7% of the average endowment value of 2006, 2007, and 2008. That averaged value is $33.4 billion, 7% of which is $2.34 billion, or

123. UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT (UPMIFA) § 4(d), 7A U.L.A. pt. 3, at 17 (Supp. 2008).

124. *Id.* § 4(a)(3), 7A U.L.A. pt. 3, at 17.

125. *Id.* § 4(d), 7A U.L.A. pt. 3, at 17.

the equivalent of a 9% payout rate for 2009's endowment value.[126] Harvard's announced 2009 payout is a mere 4.6% of its 2009 endowment value.[127] Under UPMIFA's standards, that would be a payout rate of only 3.7%. In other words, the law would not only not restrict Harvard and other universities in their spending, but also liberate more than an additional $1 billion for Harvard's use. Thus, those who would argue that UPMIFA restricts elite universities during times of crisis have to account for Harvard's decision not to use an additional $1 billion.

E. *Conclusion*

The law unquestionably restricts university spending in some capacity. UMIFA, where in place, will restrict a university from freely spending underwater endowments. UPMIFA places a soft spending limit of 7% of the endowment as the prudential baseline. And donor intent remains something of a barrier. But, as this Part has demonstrated, these restrictions apply to a lesser extent to elite universities and are insufficient to explain university behavior. To explain this behavior, we must turn to the finance of university endowments.

IV. THE FINANCE OF UNIVERSITY ENDOWMENTS

The best existing explanations for university reaction to the financial crisis of 2008 come from the way that elite universities have managed their endowments over the last twenty years. Universities have, in this time, engaged in a radical new endowment management style that provides superior returns by capturing "liquidity premiums"—or the increased value "that investors will demand when any given security can not be easily converted into cash, and converted at the fair market value."[128] Consequently, much of university investment is illiquid—to access the investment, especially during a time of crisis, universities would have to sell their investments at a steep discount, potentially as much as 50%.[129]

Many commentators have credited this illiquidity as the reason why elite universities have made their budget cuts—universities cannot access their endowments simply because their endowment investments are not easily convertible to cash. Any attempt to sell illiquid investments, the argument goes, would have resulted in a "fire sale" in a depressed market, leading to deflated returns. Facing that market landscape, universities made the determination that

126. See Appendix B for more data.

127. HARVARD UNIV., *supra* note 96, at 3.

128. *Liquidity Premium Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/l/liquiditypremium.asp (last visited Nov. 7, 2010).

129. *See infra* Table 1.

cashing out illiquid investments would result in devastation to their endowments that they could not stomach. The alternative—a disruptive and extensive set of budget cuts—proved more appetizing. The point here is to distinguish between what universities *had* to do from what universities *chose* to do. While liquidating endowment funds was not ultimately deemed desirable, it remained a possibility.

Some might think that a lack of liquidity explains why universities have reacted as they have to the financial crisis. But even this explanation is incomplete. This Part explores the financial arguments for why universities do not convert their investments into cash sufficient to stabilize their budgets during times of crisis. It also shows that while universities *do not* liquidate portions of their endowments, this does not mean that they *cannot* liquidate much of their endowments. Doing so would require taking a significant loss of face value in the investments. During a financial crisis, selling positions in markets where there are few buyers means that the university would get its "lungs ripped out," to use one colorful market description of what universities faced during the crisis.[130] The fact that the university does not choose to explore that path may be sensible. It may be prudent. But it also reflects a value choice: the university deems taking such a loss on its illiquid investments as a greater loss than those caused by budget cuts. Making sense of that trade-off requires an explanation beyond pure finance.

A. *The Yale Model and the Change to Endowment Management*

The conservative investment strategy outlined above in the period before the Cary/Bright study that prompted the overhaul of endowment management laws has given way to a more aggressive investment approach. Called the "Yale Model" for the school that has most successfully pursued it, the new strategy uses endowment funds to invest in a variety of instruments that are alternatives to traditional investments in public equities and bonds, such as timber, real estate, hedge funds, private equity, and venture capital.

The Yale Model revolutionized the way universities manage their endowment funds. David Swensen, Yale's Chief Investment Officer since 1985 and the main proponent of the Yale Model, makes the argument simply: public equity markets are so efficient that opportunities for significant appreciating investment require a great deal of luck or an exceptionally rare kind of skill that may not be possible to develop.[131] In order to maximize the return to the university through endowment income, universities should have as their goal

130. Nina Munk, *Rich Harvard, Poor Harvard*, VANITY FAIR, Aug. 2009, at 106. The actual quote is from a money manager who told Harvard investment officers that, if they were desperate to sell, he would be "happy to rip [their] lungs out" and pay fifty cents on the dollar.

131. *See* SWENSEN, *supra* note 95, at 7-8.

the greatest returns possible, and those returns are not going to come exclusively through the public equities markets. Because universities take the long view in so many respects—tenure, after all, is a commitment to a faculty member for several decades—universities are well positioned to capture liquidity premiums, or the benefits that come to those willing to trade easy conversion to cash for higher returns. If universities can forgo the need for easy cash, they will be able to time liquidity conversions more favorably and thus reap higher returns than others with more impatient liquidity needs could muster.

Additionally, Swensen's program follows a strict allocation of assets into various areas, including public equity, bonds, emerging markets, alternative investments (like timber, energy, and real estate), and private equity.[132] The Yale Model works like this: When a surge in real estate prices pushes Yale's real estate investment from a target 10% of the overall endowment to 12%, Yale will sell the additional 2% in order to bring that percentage allotment back down to its target. Similarly, when a sudden drop in real estate prices causes that target to fall to 8%, Yale will buy more real estate until the overall investment in real estate once again reaches its target. In this way, the Yale Model forces the university to sell high and buy low. The model has paid handsome dividends to Yale. Including the losses that have occurred in the present environment, Yale has had an annualized return of 16% in the decade ending in June 2008.[133]

B. *The Yale Model and Liquidity Problems*

The problem with this system, the argument goes, is that, in the event of unprecedented financial disaster, a university has few liquid assets to make available for (1) the purchase of newly cheap investment opportunities, (2) increased collateral obligations to partners such as hedge funds and private equity firms, and (3) funding of obligations to the operating budget. Thus, the Yale Model may well be the explanation behind elite universities' reactions to the financial crisis, but only if the commitments to these alternative investments meant that there was genuinely no liquidity available.

Without more, this explanation is still insufficient to explain university behavior during the crisis. First of all, while universities still hold illiquid assets—including legally binding commitments to private equity firms that require *additional* capital calls when the funds start to deteriorate—a university's ability to take the long view means that its own present-day financing needs should exist separately from the market's valuation of its

132. *Id.* at 181-244.

133. Daniel Golden, *David Swensen and the Yale Model: Cash Me if You Can*, PORTFOLIO.COM (Mar. 18, 2009), http://www.portfolio.com/executives/2009/03/18/David-Swensen-and-the-Yale-Model.

assets. In other words, if the university has to sell illiquid assets at fifty cents on the dollar today to fund obligations to the university, then that loss could reflect the university's determination that its short-term needs are a priority over maintaining the endowment at as high a level as possible. The university has earned the liberty to take that sort of loss because of the many previous years of significant growth. This is the very essence of countercyclical spending. When times are good, the endowment saves. When times are hard, the endowment pays, even if—by definition of "hard times"—markets are depressed and previously valuable assets have reduced value.

Another problem is the question of how much of the endowment is actually illiquid. Harvard, again, provides some data on asset distribution. In 2008, the university named eleven separate categories of endowment investments listed below in Table 1, with their dollar amount. In Table 1, I list the percentage of total investment that each category represents and whether the category is liquid. Here, I define "liquid" as whether or not there is a transparent trading market for the investment.[134]

TABLE 1
Endowment Liquidity by Asset Class

Category	Amounts (In Millions)	% of Total Endowment	Liquid?
Domestic equities	$ 5,085	14%	yes
Foreign equity	$ 5,143	14%	yes
Emerging market equity	$ 4,304	12%	yes
Private equity	$ 5,163	14%	no
Domestic bonds	$ 1,838	5%	yes
Foreign bonds	$ 1,331	4%	yes
Inflation-indexed bonds	$ 3,042	8%	yes
High yield	$ 865	2%	yes
Liquid commodities	$ 4,217	11%	yes
Timber/agricultural land	$ 2,620	7%	no
Real estate	$ 3,438	9%	no
Total	$ 37,046	100%	—
Total percent of liquid investments	—	70%	—

The Table shows that, if my simplifying presumption that investments in instruments traded on transparent exchanges constitute liquid investments, then a startlingly high 70% of Harvard's endowment was considered liquid in 2008. A caveat is appropriate here. University finances are opaque and complex. This data may not present the full story of Harvard's liquidity problems. But it does present enough information to at least shift the burden of proving illiquidity

134. HARVARD UNIV., *supra* note 88, at 12. I take the asset allocations from the financial report and assign them the category of liquid or illiquid according to whether there is a public market for the asset in question.

away from those with access to only the public reports and toward those who claim that illiquidity prevents universities from dipping further into their endowments to prevent budgetary instability.

Whether universities are refusing to sell at a loss because of a risk of utter devastation to an endowment in today's environment is largely an empirical question in need of data analysis on the types of investments and the market for those investments today. But it is altogether reasonable to assume that though losses would certainly result from seeking liquidity in an illiquid market, universities could still succeed in raising more liquidity if they chose to do so. Indeed, there is evidence that, in Harvard's case, such liquidation occurred.[135] Whether that choice was prudent would depend on how the costs associated with budgetary instability compared with the costs of selling illiquid positions in a down market.

Interestingly, David Swensen himself views universities' complaints of illiquidity under the Yale Model with some suspicion.[136] According to Swensen, "[t]here are actually lots of ways that portfolios generate liquidity," even during a downturn.[137] These include the more pedestrian options, such as dividends from stocks, rents from real estate holdings, logging income from timber interests, and coupons from fixed-income investments.[138] In addition, the "repo" market allows large institutions to sell bonds and repurchase them at a later date, effectively granting a short-term loan with a bond as collateral. For equities, the security-lending market allows institutional investors to post equity as collateral for short-term loans on generally favorable terms. Institutional investors can also post bonds and liquidate positions.[139] In effect, even in times of crisis, there are liquidity options available to institutional investors.

In Harvard's case, there are two other dramatic decisions attributed to former President Lawrence Summers that impacted the university's liquidity. First, despite alleged protestation from the successive heads of the Harvard Management Company, the firm that oversees the investment of the university endowment, Summers insisted on keeping eighty percent of the university's operating cash invested side by side with the endowment.[140] Although this

135. Gillian Wee, *Harvard Retreated from U.S. Stocks as Market Tumbled*, BLOOMBERG (Feb. 11, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aHqu7Y6OsBtA.

136. *See* Seth Hettena, *Yale's Financial Wizard, David Swensen, Says Most Endowments Shouldn't Try to Be Like Yale*, PROPUBLICA (Feb. 18, 2009), http://www.propublica.org/article/yales-financial-wizard-david-swensen-says-most-endowments-shouldnt-try-to-b.

137. *Id.*

138. *Id.*

139. *Id.*

140. Beth Healy, *Harvard Ignored Warnings About Investments*, BOS. GLOBE, Nov. 29, 2009, http://www.boston.com/news/local/massachusetts/articles/2009/11/29/harvard_ignored_warnings_about_investments.

strategy created enormous upside during the Summers tenure, the policy went unchanged, and ultimately cost the university approximately $1.8 billion.[141]

Second, Harvard entered derivative contracts called interest rate swaps in 2004 that locked in lending rates at the then prevailing 2.25%.[142] The contracts were such that counterparties would cover the difference if interest rates increased—that is, if Harvard's lending costs increased to, say, 5%, counterparties including Goldman Sachs would pay the difference. On the contrary, if interest rates dropped below 2.25%, Harvard would pay the difference to the counterparties. In 2004, with the economy surging, the idea that interest rates would fall to zero appeared extremely remote. Nevertheless, that is precisely what happened. As the Federal Reserve slashed rates almost to zero in 2008 during the financial crisis—where they have stayed since—Harvard faced collateral calls to its counterparties nearing an additional $1 billion. In order to terminate these contracts, the university had to pay $500 million in early termination fees.[143]

Reports conclude that this triple whammy—the plunge in endowment value, the loss of nearly $2 billion in operating cash, and the swaps debacle—resolved, for Harvard at least, the question of why it sought to cut budgets to shore up its ailing endowment. But, of course, this analysis only further begs the question: why not liquidate more of the endowment holdings in order to weather this financial typhoon? If Harvard, still sitting on $26 billion of endowed funds, felt so strapped for cash, it could have turned to its capital reserves, which were still available. Arguments to the contrary—legal or financial—are insufficient.

Perhaps, though, during the worst months of the financial crisis, when so many financial markets—from public equity to real estate, private equity to credit—were extremely volatile or completely frozen, liquidity became an impossibility. This argument is highly dubious, however. According to one source, Harvard's attempt to liquidate private equity positions, for example, failed not because there was no available buyer of those positions, but because there was no available buyer at the price the university sought.[144]

C. *The Trade-Off Between Forced Sales and Budgetary Disruption*

The crux of the question of whether endowment illiquidity explains university behavior during the crisis hinges on whether the liquidity that was available would have required endowment devastation of proportions larger

141. *Id.*

142. Michael McDonald, John Lauerman & Gillian Wee, *Harvard Swaps Are So Toxic Even Summers Won't Explain*, BLOOMBERG (Dec. 18, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aHQ2Xh55jI.Q.

143. *Id.*

144. *See id.*

than the benefit to the university budget. This is a very difficult question, and requires more than simply an economic analysis of the cost of liquidity: it requires an understanding of how universities are valuing the trade-off between endowment liquidation and budgetary instability.

It seems clear that, during this crisis, universities have decided that the cost of cutting budgets, firing staff, or even taking on additional debt is cheaper than the expected losses that will come from cashing out investments in illiquid assets during a market downturn. Descriptively, this may be precisely why universities have sought to find additional funds through budget cuts rather than endowment payouts. The value that some illiquid assets may inherently have, and may show in the coming years, could exceed the value that the university places in retaining staff, programs, budgets, or more. The question remains, however, *how* universities make this determination. Is the trade-off between cutting extraneous budgetary obligations, on the one hand, and forcing a fire sale of the university's most valuable investments that will rebound significantly in calmer markets, on the other hand? Or is the trade-off between dipping into large capital reserves and disrupting essential university functions? That question is the pith of the matter: if the latter is correct, and universities have decided that endowment preservation trumps budgetary stability, even where they have sufficient liquidity to be less disruptive to operations budgets, then more than mere liquidity pressures are at play.

D. *Other Financial Explanations for University Behavior*

There are other economic reasons that universities may have been restricted in accessing their endowments. Because universities have made use of external lending finance—principally through selling bonds—a university's creditworthiness becomes a significant issue. Indeed, at least three of the five universities with the largest endowments—Stanford, Harvard, and Princeton—have raised external funds through bond markets since the market tailspin in early 2008.[145] In order to borrow at reasonably low rates—from 4% to 6%—these universities depend on their AAA credit rating from rating agencies such as Moody's. For Harvard, Moody's has made clear that the maintenance of this AAA rating is connected to Harvard's ability to resolve "liquidity pressures" that stem from endowment losses and the increased contractual obligations to provide more capital to hedge funds and private equity groups.[146] Universities in this situation, then, may claim they are unable to further spend down the endowment because of how the credit markets will evaluate a decision to press further on an already-distressed endowment.

145. *See* sources cited *supra* note 14.

146. *Financial Update: Harvard Retains Triple-A Rating, Princeton Foresees Deeper Cuts*, HARV. MAG., Apr. 8, 2009, http://harvardmagazine.com/breaking-news/financial-update-harvard-retains-triple-rating-princeton-foresees-deeper-cuts.

Again, the financial explanation for elite universities' inability to access liquidity through their capital reserves is somewhat stronger than the legal or theoretical explanations considered above. Moody's explicit requirements for the maintenance of Harvard's credit rating are an example of the strength of this argument. The question remains, however, whether universities maintain control to the extent that they could liquidate—at a loss, and even to the point of raising the cost of borrowing on bond markets due to a credit downgrade—enough of the endowment to weather a financial crisis with minimal budgetary disruption. The financial realities that universities face, given their portfolio allocations and the realities of credit markets, may be convincing: universities have deemed that the costs of budgetary instability are less than the costs of increased endowment instability.

The financial story that animates universities' efforts to stave off financial crises through a combination of endowment spending and budget cuts makes logical sense, but only if we accept the proposition that the alternative—liquidating significantly more of the universities' endowments—is no longer on the table. Exactly why that option was largely rejected continues to be an open question.

V. THE CULTURE OF UNIVERSITY ENDOWMENTS

Some might end the inquiry here. But the question remains *how* universities have determined that they could not afford to further liquidate their endowments to avoid budgetary disruption. It is tempting to infer, from the universities' behavior, that they conducted a cost-benefit analysis, and simply found that the benefits of budget cutting and endowment saving exceeded the costs, end of story.

The problem with that admittedly simplistic analysis is in the definition of the costs and benefits of such decisions. The benefits of such cuts are quite easy to measure: the benefits of staff layoffs are the saved compensation that the former employee will no longer receive. The costs, however, are much more difficult to measure: how much value does an extra program add to the university's mission?

Because these determinations, in a university setting, are divorced from profit generation—the easiest rule of thumb for for-profit corporations—many of these questions require value judgments. The result is cut staff, sports teams, and graduate students, increased class sizes, and library closures.[147] In this Part, I propose that universities have made the decision to preserve endowment value at the expense of their operating budgets in part because the endowments have gained significant value independent of their direct contribution to the universities' economic health. The cost of endowment liquidation is a stiff price to pay: when a university administrator is facing the inevitable decision

147. For a full list, see Appendix A.

between budget cutting and endowment liquidation, it comes down to more than dollars and cents. In the age of the Yale Model of sweeping growth, university endowments have taken on a salience that makes endowment preservation one of the core university principles to which university administrators will dedicate their careers. Under this framework, liquidating endowment funds in order to shore up the university's budget makes as little sense as selling its dormitories. The endowment, to some extent, gains value to the university simply in retaining as much of its size as it possibly can.

A. *The Sacred Endowment and the Popular Endowment*

The idea that a university endowment must never lose its value is not new. Consider this description of endowments from 1922:

> College endowment is a fund, the principal of which is invested and kept inviolate and only the income used for the general support of the college, or for some specific object in connection with it. The fund thus established is sacred and should not be touched or encroached upon for any object whatsoever; its income alone is available. Unless this fundamental fact is understood and respected, the endowed college is built upon an insecure foundation. A college has no right, moral or legal, to "borrow" from its endowment, to hypothecate endowment securities, to "invest" endowment in college buildings and equipment, or, in fact, to do anything with endowment except to invest it so that it will produce a certain and steady income.[148]

The idea that an endowment must remain sacred to the university, therefore, has a long history extending far beyond the current era of unprecedented endowment growth.

Earlier, I noted that the popular definition of a university's endowment is quite different from the legal definition. This distinction is significant in understanding the "sacredness" of the endowment. The legal endowment refers exclusively to those donor gifts that are restricted for some period of time, usually in perpetuity. But in the popular sense of the word—indeed, the only sense in which the word is generally used—the endowment refers to all of the university's capital reserves. Stanford University Provost John Etchemendy recently made this conflation of the popular and legal endowment explicit. In response to a question of why the university does not spend more of the endowment during the financial crisis, rather than using the operating budget to bridge a deficit gap, he responded "[t]hat money [paid out this year] is entirely out of the corpus of the endowment, not investment income, because we didn't have investment income this year."[149] Note the conflation. The university likely did not spend down its endowment, in the legal sense, probably spending investment income accrued from previous years instead. In the Provost's mind, any previous year's reserved investment income automatically became part of

148. TREVOR ARNETT, COLLEGE AND UNIVERSITY FINANCE 24 (1922).

149. Messinger, *supra* note 35.

the university's overall endowment. The law does not concur in this determination; the popular understanding of the term "endowment" does.

There is a connection between the view of the sacred endowment, in the legal sense as used in the quote above, and the use of the term to refer to all of the university's capital reserves. Under the legal understanding, a university in financial crisis might still dip into its non-endowed capital reserves while maintaining the integrity of its donor-endowed funds. But the distinction between donor-endowed funds and other capital reserves has increasingly been lost in the discourse on endowments. The endowment today, for better or worse, is seen as the total whole of the university's capital reserves. If university administrators adopt the view that endowment preservation and growth is the hallmark of their appointment, and that the endowment "is sacred and should not be touched or encroached upon for any object whatsoever," it is wholly unsurprising that the trade-off between endowment liquidation and budgetary instability tilts decidedly toward the latter.[150]

B. *University Administrators and the "Legacy Costs" of Endowment Accumulation*

The incentives and backgrounds of university administrators—ultimately those who make the decisions about endowment spending—may have much to do with a hypothesized view that the endowment must be preserved at all costs. Hansmann wrote in his authoritative article on university endowments that the trustees of universities, who oversee endowment spending, "generally come from the business world rather than the academic world" and "are often in a poor position to exercise meaningful oversight over the actual operations of the institution. The management of the endowment, on the other hand, is closer to their areas of professional expertise."[151] In other words, because trustees come from a world where money is the primary benchmark of success, trustees and endowment managers may seek to use the same rubric for success in the management of the university. Since fundraising and endowment growth are the primary avenues for using financial benchmarks in university administration, it is unsurprising that university administrators will consider growing—or dampening the losses of—the university's endowment as a priority. By this standard, the higher the growth of an endowment, the more successful the trustee. Conversely, the further an endowment slips, the less successful the trustee.

The same could be said for university presidents and deans, although both tend to come from within academia, rather than outside of it. It has long been noted that the role of the university president is largely one of increasing the

150. ARNETT, *supra* note 148, at 24.
151. Hansmann, *supra* note 23, at 37.

financial clout of the institution, usually by fundraising.[152] The endowment is the measurement of that success. A university president who oversees a decline in the endowment will not, under this rubric, be considered a successful president. While budgetary disruption can cause political problems for university administrators, intentional endowment disruption could cause legacy problems—that is, an intentional spending down of the endowment could cast a pall of failure on the president that could last for years after the president leaves her post. This could explain the heavy bias toward resolving budgetary crises with budgetary disruption rather than with endowment disruption.

This dynamic is a variation on the concept of agency costs long articulated in the for-profit setting.[153] As noted, both Core et al.[154] and Fisman and Hubbard[155] articulate an application of agency theory to the managers of nonprofit institutions, including universities. Under that theory, the agency relationship is between the donor of the charitable gift and the managers hired to administer that gift for the ends selected by the donor.

In the context of using endowment growth as a benchmark for administrative success, however, the agency model may be significantly different. The costs described by Core et al. and Fisman and Hubbard are relatively straightforward applications of agency theory: managers of nonprofit institutions with excessive endowments will be tempted to shirk, steal, or otherwise misuse resources for their personal benefit, at the expense of the original donor's intent.[156] But when a university administrator seeks to aggressively build the endowment with only reputational benefits in mind, even at the expense of present students' or donors' intentions, the costs are quite different. Here, the university arguably shares in the benefits of the administrator's quest to burnish her legacy. But it is possible that efforts to grow the endowment for its own sake, and not as an instrumental good toward some other educational or academic end, could come at the detriment of the university and its students. We might term these costs not agency costs, but rather legacy costs, and the excessive accumulation of endowments may be prime examples of a cost to the core institution because of the legacy interests of university administrators.

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152. W. Bruce Cook, *Fund Raising and the College Presidency in an Era of Uncertainty: From 1975 to the Present*, 68 J. HIGHER EDUC. 53, 54 (1997) (surveying the change in university presidency from an academic to a financial role).

153. *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

154. *See generally* Core et al., *supra* note 56.

155. *See generally* Fisman & Hubbard, *supra* note 37.

156. The classic example here is the Kamehameha Schools Bishop Estate. An investigation by the Hawaii Attorney General prompted the removal and resignation of five of the trustees of what had become a $10 billion estate. The charges were conventional examples of agency costs: incompetence, favoritism, conflicts of interest, and private benefit from managing the trusts. *See* Gary, *supra* note 62, at 594.

C. *Endowments and Interuniversity Competition*

Elite universities may also use the absolute size of their endowment as a source of competition. These universities compete on most fronts, principally for students, faculty, government funding, and to a lesser extent, private funding. University administrators may use the size of their endowments to suggest an implicit promise of increased funding opportunities, for example, for a professor, or as a sign of permanence to an applicant or admitted student.[157] If the university has a large endowment, it can be a point of reference and pride akin to a winning football team, the prominence of a faculty member, or the ranking of the university. The tendency to rank institutions, particularly universities, is strong. The absolute size of an endowment provides a clear criterion for objective ranking. If endowments provide that benefit, and university administrators are charged with increasing the university's prestige and esteem—particularly vis-à-vis competitors—then raiding the endowment could carry a much higher cost than raiding the budget.

D. *Political Cover for Budget Cuts*

The financial crisis may also represent the opportunity to make budget cuts that, during boom years, would have been politically impossible. Simply because universities have not spent like drunken sailors, as has been suggested,[158] does not mean that universities do not have room to cut costs and make budgets that better reflect the university's priorities. External financial distress may provide cover for administrators to make those cuts that the administration deems necessary, but that vested interests—whether from students, faculty, staff, or other constituencies—would have prevented. If administrators hope to make these budget cuts in a way that will minimize their own reputational harm, a financial crisis may provide the opportunity to make desired cuts without facing political fallout. In that sense, the endowment is not tapped simply because the endowment is wholly unrelated to the desired budget cuts in the first place, and administrators are keen on making the cuts regardless of the external market turmoil.

Administrators at Stanford University have explicitly sought to use the crisis as an opportunity to make dramatic, strategic cuts to the university's operations. In the words of Provost John Etchemendy, "We want to emphasize structural and strategic changes within units. . . . That's code for: never let a good crisis go to waste."[159] The crisis may therefore present universities with the opportunity to make cuts that had long been desirable from the

157. See Hansmann, *supra* note 23, at 27-29, for a more detailed discussion of this point.

158. *See supra* Part II.

159. Messinger, *supra* note 35.

administrators' perspective, but had been, until that point, politically unfeasible.

E. *Endowment as Core University Mission*

For at least the reasons stated above, the endowment may have worth beyond its financial value, however sizeable that value might be. Thus, the value of the endowment, to the extent that it burnishes the university's reputation, becomes not simply a means of accomplishing other, more traditional university missions, but an end in and of itself. Endowment growth can become, then, a core university mission. In that sense, the endowment is similar to museums, libraries, or other valuable university assets that are not maintained merely for their monetary value. The extent of this value is certainly open to debate. But the fact that universities have failed to tap their endowments more extensively during this economic downturn when such tapping was possible suggests that universities see more value in the endowment than what finance would suggest. For that reason, I argue that the endowment is more than a future funding source; instead, it is an asset with inherent value beyond the dollar amount reported at the end of each fiscal year.

CONCLUSION: IMPLICATIONS OF THE CULTURAL ENDOWMENT

I have argued that elite universities find themselves facing scarcity amidst still unrivaled wealth, in part because these universities view their endowments as symbols of their prestige. The cultural value that endowments offer to universities can explain any residual hesitation that universities have shown in liquidating these investments in order to maintain precrisis budgets. The law restricts endowments in some respects, illiquidity in others. But in neither case are universities completely limited from spending, even significantly, their endowments. They do not do so, then, because they choose an alternative, one animated by an interest in maintaining the endowment for the endowment's sake.

In announcing a new theory of endowment accumulation, it is important to include a few caveats. First, the analysis above is limited, in some instances only to Harvard, in other instances to the five private universities with the largest endowments. Thus, the question of why universities do not tap their endowments to prevent budgetary instability during financial crises only applies to those universities with endowments that survived the crisis in good enough shape to offer economic value to their universities, including those universities with losses of other significant funding sources. While a cultural endowment can explain other universities not broached in this study—small, well-endowed liberal arts colleges, for example, likely experience the same dynamic in their endowment accumulation—the assumptions and arguments that are valid for these institutions may be invalid for others. Future research will provide fruitful opportunities to analyze some of the questions raised in this Note.

Second, this Note passes no judgment on the utility of some of the budgetary decisions made by university administrators during and after the financial crisis. Some of the budget cuts implemented in response to the financial crisis may have been prudent even during times of significant endowment appreciation. I argue, instead, that while the budget cuts may have been necessary—perhaps even beneficial to the overall university—they are nevertheless disruptive. This Note seeks to understand the narrower issue of why universities do not use their endowments to wholly offset such disruption, as the theory of the endowment would suggest.

The cultural theory of endowment accumulation—including the "legacy costs" that university presidents and deans may exact from their institutions—calls for fuller theoretical and empirical research in order to identify more fully how much this cultural value contributes to endowment accumulation, what constitutes an excessive endowment, and what the implications for public policy are. These empirical tasks, however, as important as they are, are also very difficult: universities will be slow to release granular, comprehensive data about endowment allocations, individual endowment fund performance, and the inner workings of the decisionmaking process wherein the value judgments between endowments and budgets are made. Indeed, the scant data provided in this Note required a great deal of sleuthing and maneuvering to track down information, including some hostile questioning by various university librarians[160] and other individuals managing private repositories of the data. The value of such information to markets is not insignificant. Perhaps more meaningfully, the potential for university constituencies to react with hostility if endowments become fully transparent is high. If this Note is correct in describing an administrator's assessment of an endowment as carrying value beyond a source of future income, then those most directly affected by budget cuts who disagree with such value judgments should continue asking the hard questions about how university endowments are managed.

Nonetheless, the difficulty in exploring the topic is exceeded, in my view, by the scholarly and policy value gained from a better understanding of these important dynamics. As noted in the Introduction, the Senate Finance Committee has largely stopped asking those hard questions because of endowment performance in the financial crisis. With that suspension, most of the debate about university endowments' spending habits has similarly ceased. At the very least, this Note seeks to raise questions about whether that suspension makes sense. The financial crisis may offer more opportunity, not less, to debate the utility and utilization of university endowments, the appropriate role of the endowment in the university, and whether university

160. Fortunately, this does not include the extraordinary staff of the Stanford Law School Library, who have been unendingly supportive of this research.

financial behavior during the financial crisis does not implicate important public policy concerns worthy of continued inquiry. Endowments receive a variety of public support, largely through the tax code. They are thus appropriately the subject of public inquiry. Rather than deflecting the need for that inquiry, the financial crisis shows why the role of endowments in university budgets and in society at large is as relevant as ever.

APPENDIX A: EXAMPLES OF BUDGET CUTS AT ELITE UNIVERSITIES

This Appendix provides, in list form, several of the budget cuts publicly announced by each of the five universities with the largest overall endowments: Harvard, Yale, Stanford, Princeton, and MIT. Based on personal interviews with current and former senior university administrators at two of these universities, it is very likely that other significant budget cuts have occurred without formal reporting. I leave out such instances of budget cuts, simply because of the difficulty in finding sources for them. It is probably true, though, that universities have engaged in even deeper cuts than discussed here.

In addition, each individual school within a university will respond differently to the mandate for budget cuts. Given the increased reporting that comes from an active undergraduate press, most of the cuts below focus on changes impacting undergraduates. Cuts to graduate schools are detailed to a more limited extent. The list, then, is not meant to be comprehensive, but to give a fuller sense of universities' reactions to the financial crisis.

Not all of the five universities have reacted uniformly: MIT and Stanford have announced budget cuts of up to 15%, whereas Yale has announced that its cuts would amount to only 7.5%. Deeper questions can be posed to individual universities about the balance between endowment spending and budget cutting. That is, of course, the Note's entire purpose. There is a balance between those two positions. The questions are where does it fall in a given university and how does that university reach its conclusions. This Appendix provides an initial sense of how that balance is struck for these five universities.

The purpose of this Appendix is not to generate a sense that universities have acted unreasonably by making these cuts: I pass no judgment on the merits of any individual budgetary decision. Some cuts may well be in the best interests of the university, in times of boom or in times of bust. The point is only to give a general sense of how these universities have responded to the financial crisis.

A. *Harvard*

Harvard has laid off 275 university employees[161] and offered early retirement to others;[162] raised $1.5 billion in debt on bond markets;[163] cut hot breakfasts from undergraduate dining halls;[164] cut undergraduate academic

161. Robert Tomsho, *Harvard, Hit by Recession, Lays Off 275*, WALL ST. J., June 24, 2009, at A4.

162. Athena Y. Jiang & June Q. Wu, *Harvard Pushes Early Retirement*, HARV. CRIMSON, Feb. 11, 2009, http://www.thecrimson.com/article/2009/2/11/harvard-pushes-early-retirement-harvard-will.

163. Wee, *supra* note 14.

164. William N. White, *HUDS to Trim Breakfasts*, HARV. CRIMSON, May 13, 2009, http://www.thecrimson.com/article.aspx?ref=528206.

advising;[165] cut student employment opportunities at university libraries;[166] suspended the university's expansion into Allston;[167] cut staff and hours at university libraries;[168] cut funding for the primary care division at university hospitals;[169] cut shuttle service for students between distant dorms and the central campus;[170] cut funding for undergraduate dorms;[171] increased section sizes;[172] and suspended annual conferences.[173]

B. *Yale*[174]

Yale announced first an overall budget reduction of 5%, then 7.5%;[175] the suspension of capital projects for its business school, museum, science building, and undergraduate dorms;[176] reduced hours for some student and permanent employees;[177] 20% cuts to undergraduate government;[178] and a slowdown of library digitization projects.[179]

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165. Laura G. Mirviss, *Advising Programs, Events Face Cuts*, HARV. CRIMSON, May 22, 2009, http://www.thecrimson.com/article/2009/5/22/advising-programs-events-face-cuts-funding.

166. Bita M. Assad & Ahmed N. Mabruk, *Library Budgets Force Student Job Cuts*, HARV. CRIMSON, Apr. 22, 2009, http://www.thecrimson.com/article/2009/4/22/library-budgets-force-student-job-cuts.

167. Wu, *supra* note 13.

168. Peter F. Zhu, *Harvard Libraries Cuts Jobs, Hours*, HARV. CRIMSON, June 26, 2009, http://www.thecrimson.com/article.aspx?ref=528524.

169. Peter F. Zhu, *HMS Suspends Funding for Primary Care Division*, HARV. CRIMSON, July 16, 2009, http://www.thecrimson.com/article/2009/7/16/hms-suspends-funding-for-primary-care.

170. Lauren D. Kiel, *Undergrads Criticize Cuts to Student Life*, HARV. CRIMSON, May 12, 2009, http://www.thecrimson.com/article/2009/5/12/undergrads-criticize-cuts-to-student-life.

171. Bita M. Assad & Ahmed N. Mabruk, *25 Percent Budget Cuts May Affect House Administrators*, HARV. CRIMSON, May 15, 2009, http://www.thecrimson.com/article.aspx?ref=528215.

172. Noah S. Rayman & Elyssa A.L. Spitzer, *FAS to Increase Section Size in Order to Accommodate Budget Saving Measures*, HARV. CRIMSON, May 15, 2009, http://www.thecrimson.com/article.aspx?ref=528216.

173. Monica S. Liu, *Nieman Programs Suspended*, HARV. CRIMSON, June 2, 2009, http://www.thecrimson.com/article.aspx?ref=528382.

174. The broad principles of Yale's budget cuts were announced in a letter to the university from President Levin. Letter from Richard C. Levin, President, Yale Univ., to Yale Univ. (Feb. 24, 2009), *available at* http://opa.yale.edu/president/message.aspx?id=85.

175. *Id.*

176. Margy Slattery, *The Recession at Yale*, YALE DAILY NEWS, Apr. 30, 2009, http://www.yaledailynews.com/news/2009/apr/30/up-close-the-recession-at-yale.

177. *Id.*

178. *Id.*

179. Paul Needham, *Yale Corporation Plans for Recession Effects*, YALE DAILY NEWS, Apr. 30, 2009, http://www.yaledailynews.com/news/2009/apr/30/yale-corporation-plans-for-recession-effects.

C. *Stanford*

Stanford has sought to cut budgets across the university by 12% to 15%.[180] This has included a 12% reduction in staff size at the Graduate School of Business (GSB);[181] cuts to the GSB's travel, food, library services, marketing activities, and printing expenses;[182] hiring freezes for forty-nine ongoing faculty searches;[183] leaving faculty vacancies unfilled;[184] overall university layoffs of 350 administrative positions;[185] and "dramatic[]" reductions in undergraduate peer advising.[186]

D. *Princeton*

Princeton announced salary freezes for the best-compensated faculty and staff;[187] a construction freeze;[188] reductions or eliminations of some scholarly activity not directly related to teaching and research, including certain outside conferences and colloquia;[189] reductions in undergraduate research opportunities;[190] reductions in graduate student funding in the humanities;[191] a dramatic reduction in campus civic engagement funding;[192] and reductions in outreach-related admissions travel.[193]

180. Mike Antonucci, *Careful Cuts*, STAN. MAG., Nov./Dec. 2009, http://www.stanfordalumni.org/news/magazine/2009/novdec/features/budget.html.

181. Joanna Xu, *GSB Lays Off Workers to Reduce Spending*, STAN. DAILY, Jan. 22, 2009, http://www.stanforddaily.com/2009/01/22/gsb-lays-off-workers-to-reduce-spending.

182. *Id.*

183. Eric Messinger, *Cuts to Hiring Will Affect Growth, Composition of Faculty*, STAN. DAILY, June 4, 2009, http://www.stanforddaily.com/2009/06/04/cuts-to-hiring-will-affect-growth-composition-of-faculty.

184. *Id.*

185. Messinger, *supra* note 35.

186. Marisa Landicho & Kamil Dada, *VPUE Begins Program Cuts*, STAN. DAILY, Feb. 2, 2009, http://www.stanforddaily.com/2009/02/02/vpue-begins-program-cuts.

187. Krystal Knapp, *Princeton University Seeks $170M in Budget Cuts*, TIMES TRENTON, Apr. 9, 2009, at A1.

188. Chetan Narain, *Endowment May Fall by 30 Percent*, DAILY PRINCETONIAN, Apr. 7, 2009, http://www.dailyprincetonian.com/2009/04/07/23295.

189. Nan Hu, *Departments Prepare for Budget Cuts*, DAILY PRINCETONIAN, Apr. 8, 2009, http://www.dailyprincetonian.com/2009/04/08/23284.

190. *Id.*

191. *Id.*

192. Lauren Christensen, *Pace Center to Cut Operating Budget by 82 Percent*, DAILY PRINCETONIAN, Apr. 24, 2009, http://www.dailyprincetonian.com/2009/04/24/23531.

193. Sophia Jih, *Admission Office May Cut Travel*, DAILY PRINCETONIAN, May 6, 2009, http://www.dailyprincetonian.com/2009/05/06/23650.

E. *Massachusetts Institute of Technology*

MIT was the first elite university to announce significant budget cuts. The cuts entail 5% budget reductions in fiscal year 2009 and 10-15% reductions for the three years thereafter.[194] This has included delayed renovations to undergraduate dorms;[195] a salary freeze for the highest-compensated faculty;[196] an increase in student fees;[197] the closing of two branches of the library;[198] a 30-50% reduction of admissions outreach travel spending;[199] and the elimination of eight athletic teams.[200]

194. McGraw-Herdeg & McQueen, *supra* note 10.

195. *Id.*

196. Jeff Guo & Meredith L. Lis, *Deep Budget Cuts Are on the Way, Says Undergrad. Education Dean*, TECH, Feb. 24, 2009, http://tech.mit.edu/V129/N7/uahastings.html.

197. *Id.*

198. Arkajit Dey, *MIT Libraries Lays Off Staff, Plans to Close Two Branches*, TECH, Mar. 13, 2009, http://tech.mit.edu/V129/N12/libraries.html.

199. Michael McGraw-Herdeg, *Admissions Reduces Staff, Travel, Will Use the Web for Recruiting*, TECH, Mar. 6, 2009, http://tech.mit.edu/V129/N10/admissions.html.

200. Ken Belson, *Universities Cutting Teams as They Trim Their Budgets*, N.Y. TIMES, May 4, 2009, at D1.

APPENDIX B: DATA ON THE SCHOOLS' FINANCES

TABLE A-1
Endowment Value in Millions, 1999-2009[201]

	2009 (estimated)	2008	2007	2006	2005
Harvard	$25,589	$36,556	$34,635	$28,916	$25,474
Yale	$16,009	$22,869	$22,530	$18,031	$15,225
Stanford	$12,040	$17,200	$17,165	$14,085	$12,205
Princeton	$11,278	$16,349	$15,787	$13,045	$11,207
MIT	$ 7,048	$10,069	$ 9,980	$ 8,368	$ 6,712

	2004	2003	2002	2001	2000	1999
Harvard	$22,144	$18,849	$17,170	$17,951	$18,844	$14,256
Yale	$12,747	$11,035	$10,524	$10,700	$10,085	$ 7,198
Stanford	$ 9,922	$ 8,614	$ 7,613	$ 8,250	$ 8,649	$ 6,005
Princeton	$ 9,928	$ 8,730	$ 8,320	$ 8,359	$ 8,398	$ 6,469
MIT	$ 5,865	$ 5,134	$ 5,359	$ 6,135	$ 6,476	$ 4,288

TABLE A-2
Endowment Payout Rates, 1999-2008[202]

	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999
Harvard	4.8%	4.1%	3.9%	4.1%	4.5%	4.9%	5.1%	4.8%	3.3%	4.0%
Yale	3.8%	3.8%	4.0%	4.5%	4.5%	4.5%	3.8%	3.4%	3.9%	3.9%
Stanford	5.5%	4.4%	4.5%	4.5%	4.7%	5.2%	4.7%	3.8%	4.6%	5.3%
Princeton	4.8%	4.6%	4.0%	4.0%	4.3%	4.7%	4.6%	4.2%	3.1%	3.8%
MIT	4.3%	4.3%	4.7%	4.5%	4.7%	4.7%	5.0%	4.9%	4.4%	3.4%

201. *See Total Market Values of Endowments and Endowment Rates of Return*, NAT'L ASS'N C. & U. BUS. OFFICERS, http://www.nacubo.org/Research/NACUBO_Endowment_Study/Public_NCSE_Tables_/Total_Market_Value_of_Endowments.html (last visited Feb. 17, 2007). The fiscal year 2009 category estimates the endowment value by assuming a 30% decline from fiscal year 2008. *See supra* text accompanying note 42.

202. *See* NACUBO 2008, *supra* note 47, at 246 tbl.54.

TABLE A-3
Endowment Growth, 1999-2009[203]

	2009 (estimated)	2008	2007	2006	2005	2004
Harvard	−25.0%	8.6%	23.0%	16.7%	19.2%	21.1%
Yale	−25.0%	4.5%	28.0%	22.9%	22.3%	19.4%
Stanford	−25.0%	6.2%	23.4%	19.5%	19.5%	18.0%
Princeton	−25.0%	5.6%	24.7%	19.5%	17.0%	16.8%
MIT	−25.0%	3.2%	22.1%	23.0%	17.6%	18.2%

	2003	2002	2001	2000	1999	Average
Harvard	12.5%	−0.5%	−2.7%	32.2%	12.2%	10.7%
Yale	8.8%	0.7%	9.2%	41.0%	12.2%	13.1%
Stanford	8.8%	−2.6%	−2.1%	38.4%	19.1%	11.2%
Princeton	8.2%	2.2%	2.4%	35.5%	21.7%	11.7%
MIT	1.1%	−9.9%	−3.7%	55.7%	18.6%	11.0%

203. *See id.* at 192 tbl.50. Estimate based on anticipated losses as reported in Janet Frankston Lorin & Oliver Staley, *Princeton, Williams, Amherst Benefit From 'Cheerier' Stock, Bond Markets*, BLOOMBERG NEWS, July 13, 2009.