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# **Exploring the Legal Environment for Responsible Investing by Philanthropic Foundations**

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# Exploring the Legal Environment for Responsible Investing by Philanthropic Foundations

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- II. General Principles for Investing Foundation Asset
- III. Particularities of SRIs
- IV. Tax issues
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# I. Introduction: Asset Administration by Foundations

## 1. Management of Foundation Asset

- Used to follow a conservative pattern
- New approach: «Purpose related investment», one type «sustainable and responsible investments» (SRI)
  - Considerable potential, can exponentiate purpose realizing power of a foundation
  - Purpose related investing foundations as «better foundations»?



# I. Introduction: Asset Administration by Foundations

## 2. Economic-Crisis and effects on European fiscal policy

- On-going economic struggle of EU member states
- Pressure on the European Central Bank (ECB)
- Historically low interest rates (currently 0.25%)

## 3. Consequences and Challenges

- Effect on portfolio management of foundations:
  - From interest orientation to innovative investment solutions
  - Asset allocation and management has become core part of foundation strategy



# I. Introduction: Asset Administration by Foundations

## 3. Consequences and Challenges

- New challenges:
  - Technical and economic field of asset management
  - Foundation law requirements for foundation asset investments

# I. Introduction: Asset Administration by Foundations

## Case 1

- Foundation with classical (medical) purpose, which also consists of being the main supporting source of a hospital
- Board plans to engage in sustainable investments  
→ Can the board invest? Limits?
- Imagine, investments fail:
  - Hospital which depends on support might have to close down
  - Supervising authority might replace foundation board which might also have to face liability charges



# I. Introduction: Asset Administration by Foundations

## Case 2

- Foundation with purpose (among others) to advance solar energy
  - Board decides on major investment in solar field-projects in the Middle East (high risk but considerable return on investment possible)
  - Investment fails completely due to political disturbances and mismanagement
- Violation of foundation law by the board?





## I. Introduction: Asset Administration by Foundations

The cases should demonstrate:

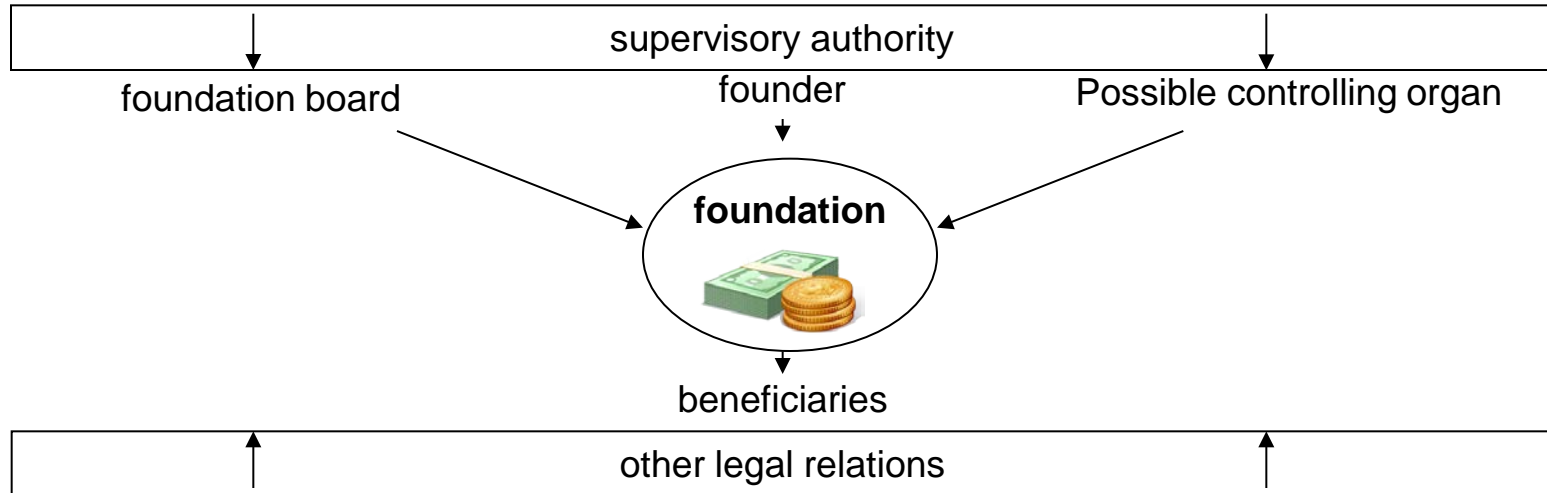
- Foundation cannot invest like a private person or company
- Due to their specific nature foundations and their boards face special (legal) restrictions
- Pure social-economic perspective has to be embedded in its legal feasibility



## II. General Principles for Investing Foundation Asset

### 1. The Foundation Asset and Its Management as a Core Element of the Foundation Organism

- How does a foundation work?





## II. General Principles for Investing Foundation Asset

### 1. The Foundation Asset and Its Management as a Core Element of the Foundation Organism

- The role of the foundation asset in the fundamental structure of a foundation
  - The asset is a **necessary element** as it provides the means to realize the foundation purposes and the will of the founder
  - The board is by no means free in the use it makes of the foundation asset
  - Management and use of the asset and the returns have to be guided by foundation purpose and statutory provisions



## II. General Principles for Investing Foundation Asset

### 1. The Foundation Asset and Its Management as a Core Element of the Foundation Organism

- The role of the foundation asset in the fundamental structure of a foundation
  - **Autonomy and discretion end** where binding prescripts are made by law or foundation statutes or where management of the asset deviates from foundation purpose and will of the founder
  - In this case, acting of the board may **violate foundation law** and can cause an intervention of the supervising authority or liability of board members



## II. General Principles for Investing Foundation Asset

### 2. State of the Art: Many Open Questions

- What are the precise **principles and duties** that follow from this fundamental relation of assets and purpose, discretion and binding prerequisites?
- Some parameters have been sketched from different sides
  - The **Swiss Federal Court** e.g. regularly holds that the asset management of a foundation needs to be guided by five principles: (1) return, (2) liquidity, (3) asset preservation, (4) diversification of investments, (5) avoidance of risks
  - **Swiss Foundation Code**, e.g. pursues a *process driven* approach



## II. General Principles for Investing Foundation Asset

### 2. State of the Art: Many Open Questions

- Some parameters have been sketched from different sides
  - Also focusing on the process of decision making: **Business Judgement Rule** (now implemented by new Liechtenstein Foundation Law)
    - board members cannot be held liable for decisions, even if the decision turns out to be detrimental to the foundation, given that the board fulfilled some essential decision making-requirements
- Yet, no **comprehensive and coherent set of legal rules** for the management of foundation asset (in CH/FL/GER)



## II. General Principles for Investing Foundation Asset

### 3. Cornerstone Principles

- a) Discretion and binding prerequisites – due exertion of discretion
  - Foundation board has to determine whether **margin of discretion** or binding prerequisites
  - «Discretion» does not mean at all that foundation board is free to decide and do whatever it feels disposed to



## II. General Principles for Investing Foundation Asset

### 3. Cornerstone Principles

- a) Discretion and binding prerequisites – due exertion of discretion
  - The due exertion of discretion is a **four step-process**: The board has to
    - (1) determine with regard to a certain issue that it has a margin of discretion
    - (2) assemble the aspects which are relevant for its decision (e.g. will of the founder) and sort out aspects which must not be considered (e.g. personal advantages)
    - (3) consider these aspects by weighing up the pros and cons for the different possible ways to decide
    - (4) take and implement a decision that reflects the result of the consideration process



## II. General Principles for Investing Foundation Asset

### 3. Cornerstone Principles

- a) Discretion and binding prerequisites – due exertion of discretion
  - In process of gathering relevant information **expert knowledge** (external financial advisors) important; yet, board is not allowed to delegate the decision as such, board's own discretion must not be replaced
  - High importance since board typically disposes of a margin of discretion with regard to many asset management issues
  - If board fails to follow these steps, it violates foundation law and may be held liable for this violation





## II. General Principles for Investing Foundation Asset

### 3. Cornerstone Principles

#### b) Two levels of guiding aspects

- «**Foundation level**»: Aspects that derive from foundation law and from the structure of the respective foundation
  - **Foundation purpose** can imply targets for the return and the liquidity that the asset management needs to generate (e.g. the maintenance of a hospital)
  - **Detailed investment allegations** in the statutory documents: Founder can e.g. determine whether the capital stock must be preserved «eternally» or can be consumed



## II. General Principles for Investing Foundation Asset

### 3. Cornerstone Principles

#### b) Two levels of guiding aspects

- «**Investment level**»: General principles that apply to the management of any asset (e.g. diversification)
- Distinguishing these two levels illustrates relation between the decisive aspects:
  - The board is bound to the foundation purpose and the will of the founder, the «**foundation level**» **takes precedence** over the «investment level»
  - If statutes oblige the board e.g. to invest part of the assets locally (even though non-local stocks promise more attractive returns), the foundation level overrides general investment principles on the investment level



## II. General Principles for Investing Foundation Asset

### 3. Cornerstone Principles

- c) An important example: the **taking of risks**
  - Common rule of capital markets: The higher the return, the higher the risk
  - Yet, foundations were often believed to be obliged to invest in gilt-edged fixed-interest investments (which have proven to imply risks as well)
  - Due to current experiences and with regard to modern portfolio theory principles: Now established that foundations can and ought to take appropriate risks
  - What is «**appropriate**»? Has to be established by the techniques of modern portfolio management, but governed by the structure of the respective foundation



### III. Particularities of SRIs

- The **general principles** for the management of foundation assets are of direct relevance to SRIs by foundations
- Although SRIs, with their often positive ecological and social effects, constitute a promising field for foundation activities they are, from a foundation law perspective, **not automatically approvable**
- If an investing foundation **violates foundation law** principles, this violation is not irrelevant just because the investment is «SRI»
- **Crucial question:** How to reconcile SRI-considerations with investment and foundation law principles?



## III. Particularities of SRIs

### 1. Statutory Basis for SRI

- Necessary distinction: **foundations with or without statutory basis for SRI**
  - (1) Foundations with SRI as a *purpose*-element
  - (2) Foundations whose statutes (incl. the relevant will of the founder) *address SRI-activities* without making them part of the foundation purpose
  - (3) Foundations whose statutes (incl. the relevant will of the founder) *do not provide for SRI-activities*



## III. Particularities of SRIs

### 1. Statutory Basis for SRI

- (1) **Foundations with SRI as a purpose-element:** Engage in SRIs to directly realize foundations purpose
  - SRI-activity is not only possible but mandatory
  - Yet, the SRI-purpose must be realized lastingly and in the best possible way
  - The SRI-purpose is not a carte blanche; expert investment knowledge is just as necessary as for any other foundation



## III. Particularities of SRIs

### 1. Statutory Basis for SRI

- (2) **Foundations whose statutes address SRI-activities without making them part of the foundation purpose:** Much depends on how SRI is addressed by statutes
- Most relevant situation: Board obliged to realize a non-SRI-purpose using returns of an SR-invested foundation asset
  - How do the investment-precepts look like?
    - If precepts are very precise, not much discretion is left; in principle, board cannot be blamed for unsatisfactory returns
    - If margin of discretion is large, the two level-structure comes into play: In principle, the foundation purpose takes priority over the investment level-aspects



## III. Particularities of SRIs

### 1. Statutory Basis for SRI

- (3) **Foundations whose statutes do not provide for SRI-activities:** Not self-evident that board is allowed to invest SR
- Usually, interpretation of the foundation statutes does not forbid to invest along SR-aspects
  - But as SRI has no distinct statutory basis, no suboptimal realization of the purpose can be justified by SRI-particularities
  - Therefore, if conventional investment offers a better risk-return-ratio than an SRI, the board may have to opt for conventional investment





## III. Particularities of SRIs

### 2. The Role of GRI-Guidelines, ESG-Parameters and other Decision Guiding Aspects

- If a foundation board invests SR, it has to make sure that its investments are indeed SR
- ESG-parameters and GRI-guidelines come into play
  - Major aspects in the board's exertion of discretion
  - SR investing foundation boards should build up internal or external expert knowledge on these «soft law» parameters



## III. Particularities of SRIs

### 3. Appropriate Investment Approach

- «SRI» includes various **investment approaches**
  - Positive or negative screening
  - Integrated investment
  - Impact Investment
  - Active ownership etc.
- Yet, investment approach must be **adapted** to the structure and possibilities of the very foundation
  - If board chooses a too ambitious approach, the need of resources may have negative effects on the purpose realization and the decision may be flawed



## III. Particularities of SRIs

### 3. Appropriate Investment Approach

- In addition, the board must
  - Establish **working structures** that foster the success of the SRIs (e.g. GRI-expert advisors or specialized committees within board)
  - Employ a considerable degree of **care and specific knowledge** to make sure that unnecessary risks and losses are avoided



## III. Particularities of SRIs

### 4. The «Foundation Planning-Perspective»

- Crucial Role of foundation statutes and will of the founder
- From *ex ante* perspective of a prospective founder, the SRI-activities of future foundation become a question of «foundation planning»
- Three planning maxims may be:
  - (1) Founder should seek expert advice on foundation law *and* on SRI-aspects
  - (2) Founder should be explicit in the fundamental precepts for the foundation: If you want your foundation to invest SR then tell her to do so!
  - (3) Due to uncertainty of future developments, founder should not fix too many details



## III. Particularities of SRIs

### 5. Cases

#### Case 1:

- Group (3): Board is most probably allowed to invest SR
- But in principle, it must not accept underperformance in investment parameters (return, risk, liquidity) which are due to the SR-character of its investments
- Particularly thorough exertion of discretion is needed to determine whether and how SRI is possible
- If and before board invests SR, it must seek advice and construe management of these investments in an appropriate way
- If done so, it can most probably not be blamed for investment failure and its consequences



## III. Particularities of SRIs

### 5. Cases

#### Case 2:

- Group (1): No violation by choosing solar field as investment
- Maybe violation by undue exertion of discretion insofar as board has chosen particular solar field with inappropriate risk-return-ratio; need to realize foundation purpose long term has to be taken into consideration
- Probably violation of obligation to carefully implement investment decisions if board carried out or could have prevented mismanagement



## IV. Tax issues

### 1. Enhanced need for efficiency

- Just transferring money to beneficiaries no longer “state of the art”
- Increasing need for more efficient use of foundations’ assets
- New forms of investments: Sustainable and Responsible/Impact Investments for creating additional value and benefit

### 2. An entrepreneurial philanthropic approach

- Investment in beneficiary by “participation” (e.g. investing in a start-up and participating in bringing business to success)
- Constantly and proactively creating value instead of grants “a-fonds-perdu”
- However: Possible “return on investment” in conflict with tax exemption



## IV. Tax issues

### 3. Principles of Tax exemption

- Classic foundations as non-profit organizations are entitled to tax exemptions; main criteria: General public interest, unselfishness (CH)
- Foundations with an entrepreneurial approach (e.g. venture philanthropy) could lose this privilege
- Criteria threatening tax exemption
  - Purpose of gain
    - Profits are ends in themselves
    - Economic purpose has priority over charitable purpose





## IV. Tax issues

### 3. Principles of Tax exemption

- Competitive situation
  - Foundations could have an advantage over other competitors due to tax exemptions
  - Foundations' contributions are offered by other commercial providers (= effective competition)

*or*

- Foundations offer extremely cheap services so that potential competitors are blocked out of the market (= monopoly situation)



## IV. Tax issues

### 3. Principles of Tax exemption

- Market-based compensation for grant-making activities
  - Grants are rewarded by the recipient
  - Might be accepted, if not received in a competitive environment
- In general, foundation must proof that tax exemption is justified: Important to treat “investment” as *grant* instead of asset investment and to reinvest potential returns according to foundation purpose
- Authorities should respect the autonomy of a foundation how to fulfil its purpose
- However: Highly unpredictable situation



## V. Summary

### 1. General Summary

- Interaction of SRI-principles and foundation (and tax) law is complex and not yet sufficiently discussed
- The here presented “cornerstones” need further development and should inspire the discussion
- Nonetheless, attempt to formulate a few “charta-like” principles



## V. Summary

### 2. Principles of Conduct for “SRI-Foundations”

- (1) The SRI-activity of a foundation must take into consideration the fundamental principles that follow on the «foundation level» from foundation law as well as from the statutes of the particular foundation. Moreover, on the «investment level» it must respect the general rules of asset management. In principle, the «foundation level» takes priority over the «investment level».



## V. Summary

### 2. Principles of Conduct for “SRI-Foundations”

- (2) In particular, foundations with SRI as their purpose are, as every other foundation, bound to realize that purpose at best possible. The SRI-activity of other foundations depends on whether and how the foundation statutes conceive a specific (SR-) investment strategy; in any case, the SRI-activity must be shaped in a way that does not contradict the optimal realization of the foundation purpose.



## V. Summary

### 2. Principles of Conduct for “SRI-Foundations”

- (3) Foundations shall apply due care in taking and implementing their investment decisions. This includes in particular that the foundation board abides by the rules of a due exertion of discretion. SRI-decisions shall, as part of a due exertion of discretion, take into consideration commonly-accepted guidelines and criteria on how to determine the SR-character of an investment. The SRI-approach must be adapted to the structure and the possibilities of the foundation.



## V. Summary

### 2. Principles of Conduct for “SRI-Foundations”

- (4) In order not to threaten the tax exemption, foundations following an entrepreneurial approach (e.g. venture philanthropy) should treat the «investment» as a grant, try to avoid a cumulation of purpose of gain, competitive situation and market-based compensation, and reinvest a possible return according to the foundation purpose.

Literature:

Dominique Jakob/Peter Picht, Responsible Investments by Foundations from a Legal Perspective, *International Journal of Not-for-Profit Law*, Vol. 15, No. 1, 2013, S. 53-67



# Thank you for your attention!

and «Save the date»:

Foundation Law Day on «Foundations and Families»

3. Zürcher Stiftungsrechtstag

Am 13. Juni 2014 in der Aula  
der Universität Zürich





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