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ARTICLES

Most colleges and universities of all sizes have an endowment, a fund that provides a stream of income and maintains the corpus of the fund in perpetuity. Organizations with large endowments, such as colleges, universities, and private foundations, all finance a significant part of their operations through the return received from the investment of this capital. This article examines the legal framework for endowment investing, endowment investing policies, their evolution to more sophisticated and riskier strategies, and the consequences evinced during the financial crisis of 2008 and beyond. It traces the approaches to endowment investing and chronicles the rise and, if not the fall, the challenges to modern portfolio management. It examines the impact of endowment losses on colleges and universities and their constituencies, as well as the problem of trustee deference to boards' investment committees. This article concludes that universities have learned little from the financial crisis and are more invested in illiquid, nontransparent assets than before the financial crisis. Finally, this article recommends the establishment of board level risk management committees to evaluate endowment investing policies.

Postsecondary education, particularly proprietary postsecondary education, has become a product-driven industry. As such, the law must apply the same accountability standards on these schools that it requires of other proprietary entities. Because the states are best positioned to regulate the institutions within their own borders, they must seize the opportunity to regulate any industry that has proliferated at the expense of its consumers because of a business model that eschews disclosures about its operations. As the cases regarding the deceptive trade practices of proprietary education institutions continue to funnel through our nation's courts, the argument for legislation requiring these institutions to disclose vital investment information to potential consumers must be given due consideration. This article examines the history of and distinction between proprietary schools and traditional postsecondary schools, the modern reality of the educational marketplace, and the organizational structure of proprietary schools, positing that the regulation of the proprietary education industry is more akin to regulating a traditional corporation than regulating a traditional postsecondary school. Ultimately, this article concludes that a fiduciary duty, existing between proprietary education institutions and their students, must supplant the academic abstention doctrine, which has long been a fixture in the court system, and finds that historical causes of action against proprietary schools are inadequate in the modern context. This article also contends that the states are better positioned to regulate harmful trade practices of proprietary schools than the federal government and makes a realistic and modern recommendation for the regulation of proprietary educational institutions.

Since the 1980s, law school tuition has risen dramatically. As a result, by early 2013, the average law school graduate could expect to graduate with debt near or exceeding $100,000, not including any debt accumulated during his or her undergraduate endeavors. Like many aspects of the legal profession, the Character and Fitness assessment, required by state bar boards of admission, has not evolved to reflect current economic and social trends, as student loans are an integral and necessary resource used by many to attend law school. Due to the increasing costs and grim financial prospects associated with the pursuit of a law degree, reform is necessary in each state's perception of student debt as a factor in a Character and Fitness assessment, specifically the applicant's financial irresponsibility determination. This article will evaluate the bar admissions process, with a specific focus on the Character and Fitness assessment and the considerations that are taken into account by a Character and

Fitness Committee before it issues a finding of financial irresponsibility. It will also examine the Loan Repayment Assistance Programs (LRAP) that are in place at the state, federal, and law school level and will argue that these programs are insufficient to address the large amounts of debt law that graduates can accumulate while pursuing a law degree. This article will further discuss whether a legal education is a wise investment, as well as analyze the various class action suits against law schools for their alleged misrepresentations of employment and salary data. Finally, this article will consider possible reforms that bar admissions boards should adopt to treat student loan debt separately from a determination of financial irresponsibility that adapts to meet the demands of twenty-first century lawyers.

NOTE

The Issue of Donor Standing and Higher Education: Will Increased Donor Standing Be Helpful or Hurtful to American Colleges and Universities?

Colleges and universities depend heavily on the charitable support of alumni, parents, and friends for the operation of their schools. Larger gifts, however, tend to be accompanied with a purpose—and certain restrictions. Donors of such gifts expect that their contributions will be administered in exactly the same way as they had intended. Sometimes, however, this is not the ultimate result. In such cases, the issue becomes whether a donor may bring suit to enforce the terms of a charitable donation. This Note will look broadly at the issue of donor standing—specifically, how it pertains to charitable donations to colleges and universities. It will also address judicial characterization and enforcement of charitable donations and analyze the case law that surrounds the issue of donor standing, ultimately focusing on how similar donations have had divergent outcomes depending on the jurisdiction. This Note will also analyze the legislative side of the issue, looking particularly at statutory divergence regarding how charitable donations are classified among various jurisdictions, as well as address possible ways to reconcile the jurisdictional differences on donor standing by looking to scholarly debate on the issue. Finally, this Note concludes by arguing that while changes in current legislation may help to create a more transparent system, they must be done in light of past judicial precedent.

BOOK REVIEWS

WHAT WENT WRONG: PRUDENT MANAGEMENT OF ENDOWMENT FUNDS AND IMPRUDENT ENDOWMENT INVESTING POLICIES

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INTRODUCTION

Most colleges and universities of all sizes have an endowment, a fund that provides a stream of income and maintains the corpus of the fund in perpetuity.[1] Organizations with large endowments, such as colleges, universities, and private foundations,[2] all finance a significant part of their

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1. The legal definition of an endowment fund is an institutional fund or part thereof, not expendable by the institution on a current basis under the terms of the applicable gift investment. NAT'L CONF. ON COMM'RS OF UNIF. STATE LAWS, UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT § 2(2) (2006) [hereinafter UPMIFA]. However, the word "endowment" generally is used in a broader sense than just the permanent corpus of the fund. Quasi-endowment is a term that describes unrestricted capital gifts that the charitable institution has decided to treat as endowment. Endowment funds are contrasted to other types of funds, such as tuition revenues, which are held for a very short term and are likely to be invested in treasury bills or commercial paper. Joel C. Dobris, *Real Return, Modern Portfolio Theory, and College, University, Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules*, 28 REAL PROP. PROB. & TR. J. 49, 51 n.4 (1993).

Accounting classifications of endowments differ. Permanent or classic endowment funds are restricted in their purposes by donors to provide long term funding for designated purposes. *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for All Endowment Funds*, Statement of Financial Accounting Standards (Fin. Accounting Standards Bd. 2008). Unrestricted net assets are not subject to donor-imposed restrictions. *Id.* Temporarily restricted net assets consist of donor-restricted endowment funds that are not classified as permanently restricted net assets. *Id.* When donor restrictions expire–a stipulated time restriction ends or a purpose restriction is fulfilled–temporarily restricted net assets are reclassified to unrestricted net assets and reported as net assets released from restrictions. *Id.* The restrictive spending policies of UPMIFA would apply only to true endowments with restrictions. UPMIFA, *supra* note 1, at § 2(2). All types of endowment categories are commingled for investment purposes and are referred to as "endowment." *Id.* At Harvard in the fiscal year 2013, 64.7% of the endowment is classified for accounting purposes as temporarily restricted; 18.1% as permanently restricted; and 17.1% as unrestricted. HARVARD UNIVERSITY FINANCIAL REPORT FISCAL 2013 18 (2013), *available at* http://vpf-web.harvard.edu/annualfinancial /pdfs/2013fullreport.pdf. Yale's figures in the fiscal year 2013 were 69.8% temporarily restricted; 15.2% permanently restricted; and 14.9% unrestricted. YALE FINANCIAL REPORT 2012-2013 15 (2013), *available at* www.yale.edu/finance /controller/reporting/reports.html.

2. Private foundations are charities that have failed certain tests of public support under I.R.C. § 509 (2012). For the 2009 tax year, 92,624 domestic private foundations reported $585.5 billion in total assets. Cynthia Belmonte, *Domestic Private Foundations and Related Excise Taxes, Tax Year 2009*, STAT. OF INCOME BULL., Winter 2013, at 115 Fig. A. Private foundations typically are funded through a gift of assets that becomes an endowment, and grants are paid out of the earnings generated. I.R.C. § 4942(e)(1) requires private foundations to spend at least 5% of their current investment asset value for charitable purposes. I.R.C. § 4942(e)(1) (2012).

operations through the return received from the investment of this capital. This article examines the legal framework for endowment investing, endowment investing policies, their evolution to more sophisticated and riskier strategies, and the consequences evinced during the financial crisis of 2008 and beyond. It does not deal, save tangentially, with issues of endowment spending policies, which have been matters of widespread commentary and disagreement.[3]

The article suggests procedures and policies to encourage college and university board practices that may better inform trustees of investment approaches and, in some cases, restrain investment strategies that increase the volatility of endowment returns. It is recommended that endowments invest with more awareness and consider more realistically the possibility of volatile negative returns, and their impact on the college or university, its beneficiaries, and the communities it affects.

I. AN OVERVIEW AND RATIONALE OF ENDOWMENTS

The world of endowments is highly stratified in terms of size, utilization of modern theories of finance, trustee governance procedures, and delegation to and reliance on outside experts. The endowments discussed herein have been artificially divided into two categories. First are the largest and most sophisticated endowments, those with assets over $1 billion, which utilize the most modern tools of finance.[4] Second are

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3. *See* RAY D. MADOFF, IMMORTALITY AND THE LAW 96-109 (2010); RICHARD POSNER, ECONOMIC ANALYSIS OF THE LAW, § 18.5 (7th ed. 2007); Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687, 725 (1999); Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873 (1997); Peter Conti-Brown, *Scarcity Amidst Wealth: The Law, Finance, and Culture of Elite University Endowments in Financial Crisis*, 63 STAN. L. REV. 699, 741–43 (2011); Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUDIES 3, 40 (1990); Sarah E. Waldeck, *The Coming Showdown Over University Endowments: Enlisting the Donors*, 77 FORDHAM L. REV. 1795 (2009); Daniel Halperin, *Is Excessive Accumulation Subsidized?*, 67 EXEMPT ORG. TAX REV. 17 (2011); Daniel Halperin, *Is Excessive Accumulation Subsidized? (Part II)*, 67 EXEMPT ORG. TAX REV. 125 (2011); Calvin H. Johnson, *Payout by Charities Over 50 Years*, 132 TAX NOTES 1161 (Sept. 12, 2011); Akash Deep and Peter Frumkin, *The Foundation Payout Puzzle* (Hauser Ctr. for Nonprofit Orgs., Working Paper No. 9, 2005), *available at* http://ssrn.com /abstract=301826. From the political world, Senator Charles Grassley has weighed in by supporting a 5 % mandatory payout of educational endowments to reduce the high costs of tuition and improve access to the middle class and poor. *See* Karen W. Arenson, *Big Spender*, N.Y. TIMES (Apr. 20, 2008), http: //query.nytimes.com/gst/fullpage.html?res=9F02EED91E3DF933A15757C0A96E9C8 B63&ref=karenwarenson.

4. In 2007, there were seventy-six endowments with $1 billion in assets and sixty-five endowments with assets from $500 million to $999,999,999. NAT. ASS'N OF COLL. AND UNIV. BUS. OFFICERS, 2007 NACUBO-COMMUNFUND STUDY OF

endowments with assets from $500 million to $1 billion that have adopted modern portfolio theories of investing, but generally may not have taken on the same level of risk in their investment strategies, nor have they had access to the most successful hedge funds, private equity firms, or investment advisors, or garnered the gains or suffered the losses of the largest endowments.

Intergenerational equity is the most commonly stated goal for endowment management. As stated by James Tobin: "The trustees of an endowment institution are the guardians of the future against the claims of the present. Their task is to preserve equity among generations."[5] This means that tomorrow's students, scientists, patients, beneficiaries, or parishioners will receive the same or greater benefits, taking into account the effects of inflation, as today's beneficiaries. Another common rationale for endowments is that they enable organizations to smooth out revenue shortfalls, so that they can maintain the same scale of activities in lean years as in bountiful ones.[6]

The financial crisis of 2008 called into question both rationales. Colleges and universities did not increase their spending rates to smooth out the endowment spending shortfalls, and budget cutbacks were so severe at many educational institutions that intergenerational equity for current students or beneficiaries was not maintained.[7]

It is difficult to find hard figures of the size of endowment funds in the

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ENDOWMENTS (2007) [hereinafter 2007 NCSE]. In 2009, there were only fifty-six endowments with $1 billion in assets and sixty-five endowments with assets from $500 million to $999,999,999. NAT. ASS'N OF COLL. AND UNIV. BUS. OFFICERS, 2009 NACUBO-COMMUNFUND STUDY OF ENDOWMENTS (2009) [hereinafter 2009 NCSE]. In 2012, seventy-one endowments had $1 billion in assets, and seventy-three had assets from $500 million to $999,999,999. NAT. ASS'N OF COLL. AND UNIV. BUS. OFFICERS, 20012 NACUBO-COMMUNFUND STUDY OF ENDOWMENTS (2012) [hereinafter 2012 NCSE]. These figures include Canadian institutions. NACUBO-Commonfund figures often differ from an institution's own report of endowment results.

5. James Tobin, *What is Permanent Endowment Income?*, 64 AMER. ECON. REV. 427 (1974). Professor Tobin was awarded the Nobel Prize in Economic Sciences in 1981.

6. Robert C. Merton, *Optimal Investment Strategies for University Endowment Funds*, *in* STUDIES OF SUPPLY AND DEMAND IN HIGHER EDUCATION 211, 211–12 (Charles T. Cotfelter & Michael Rothschild eds. 1993); Conti-Brown, *supra* note 3, at 708–09. Another view, offered by Professor Henry Hansmann, is that justifications of intergenerational equity are not persuasive and may not call for a transfer of wealth through saving from the present generation to spend on later ones. The argument for endowment accumulation should be on grounds of efficiency. Professor Hansmann suggests that the more compelling reasons for endowments are serving as a financial buffer against periods of financial adversity; helping to assure long term survival of an institution's reputational capital; protecting intellectual freedom; and transmitting prized values. *See* Hansmann, *supra* note 3, at 14, 39.

7. *See* Conti-Brown, *supra* note 3, at 702–03.

United States, but the sum is immense.[8] In the period from 2001 to 2007, higher education endowments grew annually by double digit figures led by Harvard's endowment, which ballooned from a little over $5 billion in 1993 to $36.6 billion at the fiscal year ending June 30, 2008. Yale's endowment grew from $3.1 billion to $22.9 billion in that period.

In the fiscal year ending June 30, 2008, higher education endowments lost three percent of their value in a difficult financial environment. Then the bottom dropped out. The nation's most severe financial crisis since the Great Depression occurred in fall 2008.[9] This event wreaked havoc on endowment portfolios. By the end of the 2009 fiscal year, Harvard's endowment was $25.7 billion (down 36.6% from the previous year), followed by Yale's at $16.3 billion (down 28.6%), and Stanford's at $12.6 billion (down 26.7%).[10] A survey of over 800 higher education institutions showed losses on average of 18.7%, the worst rate of return since the Great Depression.[11]

Colleges and universities with the largest endowments (over $1 billion) lost more on average (20.5%) than smaller ones because of their concentration in sophisticated investment strategies—so called alternative assets—such as private equity and venture capital investments,[12] real estate, and commodities, which involved more short-term risk and were illiquid.[13]

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8. The 2012 NCSE for the 2012 fiscal year ending June 30 found that 831 institutions consisting of 525 private colleges and university endowments in addition to 306 public education institutional endowments had $406.1 billion in assets. 2012 NCSE, *supra* note 4. These figures are only part of the total. Figures for endowment results are from the NCSE Report for the particular year mentioned.

9. FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT XV (Jan. 2011).

10. Tamar Lewin, *Investment Losses Cause Steep Dip in University Endowments, Study Finds*, N.Y. TIMES (Jan. 28, 2010), http://www.nytimes.com/2010/01/28/education/28endow.h tml?_r=0. Although the declines were the greatest since the Depression, those endowments had only fallen to their 2005 levels, and they had positive returns over the ten years ending on June 30, 2009.

11. Kenneth E. Redd, *To Ensure We Endure*, BUSINESS OFFICER, July/August 2012, *available at* http://www.nacubo.org/Business_Officer_Magazine/Magazine_Archives/JulyAugust_2012/To_Ensure_We_Endure.html.

12. Private equity consists of investments in companies, which may be held long term as the firms add value or leveraged buyouts of public companies. Venture capital involves an investment in a start-up company, which if it issues an initial public offering of securities will generate a substantial profit to investors. For example, the Yale endowment's $300,000 investment in Google produced $75 million in gains when the company went public in 2004. THE YALE ENDOWMENT 2010 19 (2010) [hereinafter YALE ENDOWMENT REPORT 2010], *available at* http://www.yale.edu/investments/Yale_Endowment_10.pdf. Investments in private equity or venture capital are typically structured as partnerships with hedge funds.

13. Despite the great recession, large endowments had better returns than benchmark results such as the Standard & Poor's ("S&P") 500 and smaller endowments. In 2008, the S&P 500 declined 38.5%, the most since a 38.6%decline in 1937. Elizabeth Stanton, *U.S. Stocks Post Steepest Yearly Decline Since Great*

Endowments of foundations, healthcare, social service, and cultural institutions were similarly affected.[14] Endowment performance recovered in the fiscal years 2010 and 2011, faltered in 2012, and rose in 2013.[15] However, the levels of 2007 have not been reached.

Large endowment institutions often fund thirty-five percent or more of

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Depression, BLOOMBERG (Dec. 31, 2008), http://www.bloomberg.com/apps/news?pid=news archive&sid=a5RkfQG30k 1k. Yale's ten-year return from 2002 to 2012 was 10.6% per annum, adding $8.89 billion to the endowment, including the disastrous decline in 2008. Its twenty year return was 13.7% per annum adding $15.8 billion in value. THE YALE ENDOWMENT 2012 32 (2012) [hereinafter YALE ENDOWMENT REPORT 2012], *available at* http://investments.yale.edu/images/documents/Yale_Endow ment_12.pdf. Harvard's endowment averaged 9.49% over ten years and 12.29% over twenty years. JANE L. MENDILLO, HARVARD MANAGEMENT COMPANY ENDOWMENT REPORT, MESSAGE FROM THE CEO (2012), *available at* http://www.hmc.harvard.edu/docs/ Final_Annual_Report_201 2.pdf.

The average ten-year return in 2012 for all educational endowments net of fees was 6.2%. 2012 NCSE, *supra* note 4, at 3. The average ten-year return for all endowments in 2009 was 4%. Goldie Blumenstyk, *Average Return on Endowment Investments Is Worst in Almost 40 Years*, CHRON. HIGHER EDUC. (Jan 28, 2010), http://chronicle.com/article/Average-Return-on-Endowment/63762/. For the fiscal year 2009, the five largest university endowments declined by 25% to 30%. Craig Karmin, *Ivy League Endowments Finally 'Dumb'*, WALL ST. J. (June 30, 2009), http://online.wsj.com/news/articles/SB12463183415797 0855. According to a survey by the Northern Trust Corp, the median loss of endowments with less than $100 million in assets that same year was 16%. *Id.* Presumably smaller endowments had a more traditional asset allocation, including more old fashioned fixed income. *Id*.

14. An annual survey by the Chronicle of Philanthropy of 221 private foundations and sixty-nine community foundations found that endowments dropped by 26% in the calendar year 2008. Caroline Preston, *Foundation Endowments Dipped in 2008, but Giving Rose*, CHRON. PHILANTHROPY (July 2, 2009), http://philanthropy.com/article/Foundation-Endowments-Dipped/6311 7/.

15. In the fiscal year 2012, the average investment return of educational endowments was 0.3% compared to 19.2% in the fiscal year 2011, 11.9% in 2010, and 18.7% in 2009. *See* 2009 NCSE, *supra* note 4; NAT. ASS'N OF COLL. AND UNIV. BUS. OFFICERS, 2010 NACUBO-COMMUNFUND STUDY OF ENDOWMENTS (2009) [hereinafter 2010 NCSE]; NAT. ASS'N OF COLL. AND UNIV. BUS. OFFICERS, 2011 NACUBO-COMMUNFUND STUDY OF ENDOWMENTS(2011) [hereinafter 2011 NCSE]; 2012 NCSE supra note 4; Press Release, Nat'l Ass'n of Coll. and Univ. Bus. Officers, Educational Endowments Returned an Average of -.3% in FY 2012, Down Sharply from 19.2% in FY2011 (Feb. 1, 2013), *available at* http://www.nacubo.org/Research/ NACUBO_Endowment_Study.html. Preliminary data from the NACUBO-Commonfund survey for the fiscal year 2013 indicates that investment returns for all college and university endowments averaged 11.7% due to the strength of the equity markets. Endowments with assets over $1 billion posted an average investment return of 11.6%, and endowments with assets between $501 million to $1 billion had average returns of 12.9% due to greater allocation to equities compared to alternative investments. Press Release, Nat't Ass'n of Coll. and Univ. Bus. Officers, Preliminary Data Indicate Educational Endowments Earned Investment Returns Averaging 11.7% (Nov. 6, 2013), *available at* http://www.nacubo.org/Documents/research/ 2013NCSEPreliminaryPressRelease.pdf.

their operating budget through the endowment's payout.[16] In response to the asset declines of 2008, colleges, universities, museums, and other charities froze or delayed construction and expansion projects, cut operating budgets, drew on cash reserves, implemented hiring and salary freezes, and ordered layoffs.[17] A few sued their financial advisors.[18] Many colleges and universities struggled to preserve financial aid. Several institutions, including Harvard, issued bonds to raise money for expenses or to allow them to hold on to illiquid assets until their price rose.[19] Rating services cut university credit ratings. On top of this, charitable giving in education and elsewhere declined as a result of the financial crisis.[20] This following discussion explores what went wrong and why it may occur again.

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16. *See* MENDILLO, *supra* note 13, at 3; HARVARD UNIVERSITY FINANCIAL REPORT FISCAL 2013, *supra* note 1, at 6 (35% budget); YALE ENDOWMENT 2010, *supra* note 12 (41.3% budget); YALE ENDOWMENT 2012, *supra* note 12, at 4 (36% budget). The most common measure of endowments is their dollar asset value. There are other measures such as endowment to expense ratios and endowment per full-time enrolled student. The endowment-to-expense ratio acknowledges that the strength of an endowment depends on the extent to which it can pay for institutional activities. Sarah Waldeck believes the endowment-to-expense ratio is the most sophisticated measure available to policymakers because it compares the endowment to an institution's actual costs and acknowledges that some schools are more expensive to operate than others. The endowment per full-time enrolled student also recognizes that some schools are more expensive to run than others but instead of using actual costs, the measure relies on the number of full-time students as a rough proxy for institutional expenses. *See* Waldeck, *supra* note 3, at 1799–1802.

17. See Conti-Brown, *supra* note 3, at Appendix B for an elaboration of the layoffs and cutbacks by the institutions with the five largest endowments. For the impact on the six Boston area institutions, see Center for Social Philanthropy Tellus Institute, *Educational Endowments and the Financial Crisis: Social Costs and Systemic Risks in the Shadow Banking System* 55–56 (2011), [hereinafter Tellus Report], *available at* http://www.tellus.org/publications/files/endowmentcrisis. pdf.

18. Conti-Brown, *supra* note 3.

19. Tellus Report, *supra* note 17, at 37–38.

20. Charitable contributions to higher education declined 57% on an inflation adjusted basis in 2008 compared to the previous year, the largest percentage drop in fifty years, and in the fiscal year 2009, giving to colleges dropped 11.9%. Kathryn Masterson, *Private Giving to Colleges Dropped Sharply in 2009*, THE CHRON. HIGHER EDUC. (Feb, 3, 2010), http://chronicle.com/article/Private-Giving-to-Colleges/63879/; Stephanie Strom, *Charitable Giving Declines, a New Report Finds*, N.Y. TIMES, June 10, 2009, at A16; Matthew Kaminski, *The Age of Diminishing Endowments*, WALL ST. J., June 6-7, 2009, at A11; In fiscal year 2010, giving to colleges and universities increased 0.5%, but on an inflation adjusted basis decline 0.6%. Press Release, Council for Aid to Educ., Colleges and Universities Raise 28 Billion in 2010, Same Total as 2006 (Feb. 2, 2011). According to the Voluntary Support of Education Survey, conducted by the Council for Aid to Education (CAE), charitable contributions to American colleges and universities increased 2.3% in 2012 to $31 billion, but the total is still below 2008's historical high of $31.6 billion. Press Release, CAE, Colleges and Universities Raise $31 Billion in 2012 (Feb. 20, 2013).Adjusting for inflation, giving is virtually unchanged, inching up just 0.2%. *Id.*

II. TRADITIONAL APPROACHES TO ENDOWMENT INVESTING

Initially, endowments were gifts of property given to institutions to provide them with a source of dependable income from rents or interest.[21] Growth was achieved primarily through additional gifts, and endowment funds were invested quite conservatively. English law encouraged this approach. There were legal lists of securities, principally governmental securities, which were presumably safe investments in which trustees could invest.[22]

In 1830, the Supreme Judicial Court of Massachusetts rejected the English rule because there were few government securities available, and they were not necessarily safe.[23] The court then enunciated the prudent person rule:

> All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.[24]

The court concluded that the trustees acted according to their best skill and discretion.[25] The prudent person rule meant that no security *per se* was

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21. Tellus Report, *supra* note 17, at 17.

22. BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 11 (1986).

23. Harvard Coll. v. Amory, 26 Mass. 446 (1830). In *Amory*, the trustees of Harvard College were directed by the terms of a $50,000 testamentary trust of John M'Lean to "loan the same upon ample and sufficient security or to invest the same in safe and productive stock either in the public funds, bank shares of other stock, according to their best judgment and discretion" paying the income to the testator's wife for her lifetime and thereafter to deliver the principal to Harvard College and Massachusetts General Hospital in equal shares to be held by them and used to further their charitable purposes. *Id.*

The trustees invested in several bank and insurance stocks as well as those of two manufacturing companies which declined in value. *Id.* The two charitable remaindermen, Harvard and Mass. General, sought to surcharge the trustees for the reduction in value of the insurance and manufacturing stocks which had declined from $41,000 to $29,000, on the ground that they were not proper trust investments. *Id.* This was the English rule at the time. Justice Putnam, who delivered the opinion of the court, rejected the reasoning behind the English rule as having "very little or no application" to American trust law because American government securities were both exceedingly limited in amount compared to the amount of trust funds to be invested and in any event not necessarily a safe investment. *Id.* at 460. Additionally, investments in private corporations were subject to suit by law whereas the government could only be supplicated. *Id.* at 461.

24. *Id.*

25. *Id.* at 463.

inappropriate, but the rule was interpreted restrictively. Some jurisdictions continued the "legal list" approach.[26]

Endowment managers spent quite conservatively. The "income" (e.g., dividends, interest, rent, and royalties) generated by an endowment could be currently expended, but the principal of the fund remained inviolate.[27] In the nineteenth century, trustees invested in fixed-income securities, such as Treasury notes and secured corporate bonds while maintaining up to one third of their portfolios in real estate and mortgages.[28] Investment practices changed at some institutions after the First World War. In the 1920s, as the stock market rose, many endowments invested in high yielding bonds and common stocks. The experience of the Yale endowment is illustrative. During the 1920s, the Yale endowment invested over one half of its assets in equities.[29] In 1930, equities represented forty-two percent of the Yale endowment portfolio, whereas the average college or university had only eleven percent.[30]

The Great Depression led to a more sober approach. In the late 1930s, Yale's treasurer decided the share of equities in Yale's portfolio should be reduced.[31] He introduced an investing template that lasted three decades: at least two dollars would be held in fixed income instruments for every

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26. *See* King v. Talbot, 40 N.Y. 76 (1869) (prohibiting investment in stocks). The prudent person rule was interpreted conservatively because courts tended to look at investment decisions on the basis of hindsight. If an investment decision turned out badly, courts often concluded that the original decision was bad. *In re* Chamberlain's Estate, 156 A. 42 (N.J. Prerog. Ct. 1931) is an example. A testator died in August 1929, two months before the market crash that ushered in the Great Depression. Between his death and the court hearing on the estate, the estate's value had declined from $258,000 to less than $200,000. The bulk of its corpus was in securities listed on the New York Stock Exchange. With breathtaking hindsight clarity, the court stated:

> It was common knowledge, not only amongst bankers and trust companies, but the general public as well, that the stock market condition was an unhealthy one, that values were very much inflated, and that a crash was almost sure to occur. In view of this fact, I think it was the duty of the executors to dispose of these stocks immediately upon their qualifications as executors. The loss to the estate resulting from their failure to act should be taken into consideration now in awarding them compensation for their services.

Id. at 43. The trustees escaped a surcharge only because the will authorized the executors to retain the stocks. For further discussion of this case, see Philip J. Ruse, *The Trustee and the Prudent Investor: The Emerging Acceptance of Alternative Investments as the New Fiduciary Standard*, 53 S. TEX. L. REV. 653, 663 (2012).

27. Dobris, *supra* note 1, at 54–55.

28. Tellus Report, *supra* note 17, at 18.

29. JOSH LERNER, YALE UNIVERSITY INVESTMENTS OFFICE: AUGUST 2006 2 (2011).

30. *Id.*

31. *Id.*

dollar in equity.[32] This may have served Yale well in the 1930s and 1940s but was unsuited in the post-World War II bull markets of the 1950s and 1960s. Yale then substantially increased its exposure to equity investments, as did other colleges and universities.[33]

A catalyst for this change was a task force report sponsored by the Ford Foundation that concluded that most college and university endowments were too conservative in their investment policies.[34] The changes in endowment asset allocation did not result from a serendipitous recognition by endowment managers who had read the work of financial economists and had concluded equities over time were a sounder investment than bonds. There were external pressures on colleges and universities and other nonprofits.

A. Total Return Investing

Commencing in the late 1960s and 1970s, nonprofits faced inflation, government cutbacks in support, limitations on tuition increases at educational organizations, and in some sectors of education, a decline in demand. These developments abetted new endowment investment strategies,[35] one of which was more liberal spending policies through what was termed "total return policies," which permitted the expenditure of capital gains as well as traditional investment income.[36] Total return investing allowed charities with endowments to spend more for current needs, and they became increasingly dependent on endowment returns for the annual budget.

Total return investing encouraged endowment trustees to downplay conservative investment strategies in favor of maximizing endowment growth. Institutions whose endowments had been wholly invested in bonds

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32. *Id.* At this time, the treasurer and trustees managed the endowment themselves, selecting individual bonds and high yield stocks for the portfolio. *Id*.

33. *Id*.

34. ADVISORY COMMITTEE ON ENDOWMENT MANAGEMENT, MANAGING EDUCATIONAL ENDOWMENTS: REPORT TO THE FORD FOUNDATION (1969). The legal impetus for the change in philosophy of investing and spending policies was another Ford Foundation sponsored report. WILLIAM E. CARY & CRAIG BRIGHT, THE LAW AND LORE OF ENDOWMENT FUNDS (1969).

35. Henry Hansmann, *supra* note 3, at 3, 10. Though gifts remained a significant aspect to endowment growth, particularly for smaller endowments, new approaches to investing provided the engine for growth. *See* FRED ROGERS, SOURCES OF ENDOWMENT GROWTH AT COLLEGES AND UNIVERSITIES 4 (2005), *available at* https://www.commonfund.org/InvestorResources/Publications/White%20Papers/Sources%20of%20Endowment%20Growth.pdf.

36. LONGSTRETH, *supra* note 22, at 24–25. A portfolio managed under a total-return policy perspective will consider the realized and unrealized gain/loss as part of the portfolio's performance, in addition to the yield. The total-return endowment investor can achieve greater returns than that of a buy-and-hold endowment.

or preferred stock, offering a reliable income stream, diversified their portfolios by allocating more to domestic and international equities and a wide range of alternative investments.[37] Concurrently, there arose an increasing use of external professional investment managers who had been converted to the principles of Modern Portfolio Theory ("MPT"), which provided the intellectual foundation for a new aggressive approach to endowment management.[38]

B. Modern Portfolio Theory

Beyond framing the prudent person rule, Justice Putnam in *Harvard College v. Amory* also offered some timeless investment advice: "Do what you will, the capital is at hazard."[39] Unless an endowment is wholly invested in risk-free assets, such as United States Government Treasuries, that admonition remains true. All investments and investment strategies carry with them some risk in a sense of possible loss of real inflation adjusted value.[40] Modern Portfolio Theory provides a framework for managing an endowment's risk through the diversification of the portfolio. No longer is the focus of risk tied to the selection of individual securities. Modern investment management examines the portfolio as a whole, rather than any given type of asset or a decision concerning that asset.

In common parlance, risk is the chance of loss. In finance, risk refers to volatility of return.[41] A fundamental responsibility of an endowment board member or investment advisor is to manage the risk of the endowment's portfolio in relation to the objectives of the fund. When an endowment's board and its outside investment managers contend with risk, careful

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37. According to the 2012 NCSE study of 831 colleges and university endowments in the fiscal year ending June 30, 2012, the average allocation for survey participants was: 15% in U.S. stocks, 11% in fixed income, 16% in international equities, 4% in cash or short term securities, and 53% in alternative investments. 2012 NCSE, *supra* note 4, at 5. For endowments of $1 billion or more, the figures were 12% in domestic equities, 9% in fixed income, 16% in international equities, 3% in cash, and 54% in alternative investments. *Id.*

38. Tellus Report, *supra* note 17, at 19.

39. Harvard Coll. v. Amory, 26 Mass. 446, 468 (1830).

40. RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. e (1) (1992).

41. Financial economists use risk to describe variation when the probabilities of possible outcomes are known. Professor Lynn Stout differentiates risk from uncertainty with the following example: a coin toss is risky but not uncertain. The probability of a coin coming up heads or tails is 50%. Returns on securities, however, are both risky and uncertain. No one knows with certainty whether securities prices will go up or down or the probability of the event. Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 641 n.30 (2003). Volatility can be measured statistically by standard deviations, which indicate the degree to which an investment has varied in the course of arriving at its mean return over a given period. Investments with the greatest volatility have the highest standard deviation and should offer the greatest return.

attention must be given to the organization's tolerance for volatility. Several types of risk need be considered, including nonmarket diversifiable risk and market risk.[42]

Nonmarket diversifiable risk, also known as *firm* or *specific risk*, relates to the risk of a particular firm or industry. One of the central findings of MPT is there are large and essentially costless gains to diversifying a portfolio.[43] Firm or industry risk can be minimized or reduced though holding a diversified portfolio of securities.[44] For example, if new car sales drop in a recession and companies that operate auto repair franchises thrive at such times and have equivalent risk and return characteristics, a portfolio with both types of companies will be less risky than if the endowment contains only equities of one type.

A diversified portfolio may contain securities across many asset classes or hold many different issuers within a particular asset class or industry. No one compensates an investor who fails to diversify so as to minimize risk. In other words, an investor cannot demand a higher return from holding a risky security if he or she could have diversified. The proverb that admonishes "don't put all of your eggs in one basket," neatly sums up diversifiable risk.[45] Diversification moderates risks that are inherent in

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42. RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. e (1) (1992).

43. John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 647 (1996).

44. Professor Stout offers this example: when fuel prices rise, airline stocks fall while the price of oil stocks rise. Stout, *supra* note 41, at 641, n.30. Investors can eliminate industry-specific risk by having a diversified portfolio of securities covering several industries. *Id.* The benefit of diversification of investments is far from a new idea. In *The Merchant of Venice*, Antonio speaks of it:

> I thank my fortune for it,
> My ventures are not in one bottom trusted
> Nor to one place;
> Nor is my whole estate
> Upon the fortune of this present year;

WILLIAM SHAKESPEARE, THE MERCHANT OF VENICE act 1, sc. 1.

45. The phrase is very old, and its origin is unknown. In 1666, Giovanni Torriano, in the Second Alphabet of Proverbial Phrases, stated: "To put all ones eggs in a panier, viz. to hazard all in one bottom [ship]." OXFORD ENGLISH DICTIONARY 91 (2d ed. 1991). Professor John Langbein offers a more contemporary example:

> [T]he investor who buys bonds issued by weaker issuers (so called junk bonds) assumes greater risk of default than the investor who only buys Treasuries. The junk bonds pay higher interest rates, compensating the investor for bearing the greater risk. But no one pays the investor for concentrating a portfolio in too small a range of asset classes or issuers. Thus, under diversification causes the portfolio to bear uncompensated risk, risk that could be largely eliminated by spreading the investments across a wider range of asset classes and issues.

John H. Langbein, *Burn the Rembrandt? Trust Law's Limits on the Settlor's Power to Direct Investments*, 90 B.U. L. REV. 375, 388 (2010). A recent example of the costs that investing and reduces risks that are not justified by the prospect of gain. A fiduciary has the responsibility of reducing or minimizing risk that can be avoided.[46]

Another type of risk affects all securities, that is, the securities markets as a whole. A recession, a downgrade of sovereign debt, a world war, or an event such as 9/11 are examples of market risk, also called *systemic* or *systematic risk*. Market risk is non-diversifiable since it is common to all securities.[47] With non-diversifiable risk, the investor must be compensated for assuming greater risk by obtaining a higher expected return. Thus, there is a positive correlation between risk and expected return.[48] MPT was an incentive to increase portfolio risk because of the lure of greater returns that would result.

MPT assumes that investors have two desires: they seek higher returns and want those expected returns to be stable and certain. Because investors prefer certainty, higher risk investments must offer higher expected returns than lower risk investments. An investor need not avoid high risk investments because she can reduce risk by investing in securities of similar risks, which are not correlated to each other—e.g. automobile

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failure to diversify may lead to involves the Cowboys Athletic Endowment of Oklahoma State University ("OSU"), which received a $165 million donation from oil man Boone Pickens to transform OSU's athletics. The endowment invested all of its assets in Pickens' hedge fund, BP Capital, as well as in an insurance program where it purchased life insurance policies on older OSU alumni. The hedge fund lost most of its value, and OSU alumni declined to die in timely fashion. The endowment, which once had assets of $400 million, declined to $125 million. *See* Ann Zimmerman, *Boone Calls the Plays as Largess Complicates Life at Alma Mater*, WALL ST. J. July 7, 2012, at A1. This is not only an American problem. Nanzan University in Nagoya, Japan lost $230 million from an investment in a derivative product called a "power-reverse dual currency bond" that was marketed to nonprofit investors. *See* Hideyuki Sano, *Japan's Temples, Universities, Hospital's Haunted by Yen Bets*, REUTERS (Jul. 23, 2013), http://uk.reuters.com/article/2013/07/22/us-japan-derivatives-idUKBRE96L0WI20130722.

46. UPMIFA, *supra* note 1 § 4(e)(4); NAT'L CONF. ON COMM'RS OF UNIF. STATE LAWS, UNIF. PRUDENT INVESTOR ACT § 3 (1994) [hereinafter UPIA].

47. Langbein, *supra* note 43, at 648.

48. Expected return is a measure of return that uses the concept of probability to take into account the volatility or uncertainty of outcomes. It is the arithmetic mean of all possible outcomes. An example is you flip a coin, there is a 50% chance of heads and a 50% chance of tails. If you wager one dollar on the flip, you will gain two dollars if you win and nothing if you lose, and the expected return is one dollar. This is determined by multiplying the probability of each possible outcome: .5 X $2 + .5 X 0 = $1.00. WILLIAM KLEIN, JOHN C. COFFEE & FRANK PARTNOY, BUSINESS ORGANIZATION AND FINANCE 242 (11th ed. 2011). This approach, the mean variance portfolio selection model, was developed by Harry Markowitz and posits that returns can be estimated by the historical mean of an asset's returns, and risk could be quantified by the historical volatility of the returns, the variance. Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952).

manufacturers and auto repair chains of equivalent risk.[49] The higher the market or systemic risk an investor accepts, the higher the rate of return should accompany the increased risk. If two assets give the same expected return, the rational investor should always select the asset with the lower risk. Correspondingly, if two assets returns have equivalent risks, the rational investor should always select the asset with the higher expected return.

By diversifying risk throughout a portfolio, investors can achieve greater portfolio returns without taking greater overall portfolio risks.[50] A portfolio that offers the highest returns with the least variance is termed efficient.[51] Individuals and institutions have differing appetites for risk. Each efficient portfolio has the highest level of return for an acceptable level of risk. Rational investors select the portfolio that best serves their taste for aggressive objectives or a defensive (conservative) strategy.[52] They can combine high risk investments with risk-free ones to lower a portfolio's overall risk. The development of the Black-Scholes Options pricing model in 1973 further enabled investment managers to quantify risk through valuing the price of options based on five variables.[53] This permitted investment managers to purchase or sell options to hedge portfolio risk.[54]

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49. Stewart E. Sterk, *Rethinking Trust Law Reform: How Prudent is Modern Prudent Investor Doctrine*, 95 CORNELL L. REV. 851, 858 (2010).

50. A measure of a security's volatility of return relative to the market as a whole is called the beta. The market as a whole has a beta of one. A beta can be derived for individual securities. The individual beta compares its volatility to that of the market beta. The Capital Asset Pricing Model ("CAPM") provides a formula for measuring expected returns on any given investment at a particular measure of risk related to the return. CAPM states that the expected risk premium on each investment is proportional to its beta. In a competitive market, the expected risk premium varies in direct proportion to the market beta. RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 189 (10th ed. 2011). CAPM allows investors to assess whether they have achieved an appropriate level of return for the risk they've assumed. STEVE LYDENBERG, MARKETS AT RISK: THE LIMITS OF MODERN PORTFOLIO THEORY 42 (2009), *available at* www.domini.com/common/pdf/Markets-at-Risk.pdf.

51. BREALEY, MYERS & ALLEN, *supra* note 50, at 192–93.

52. PETER L. BERNSTEIN, AGAINST THE GODS: THE REMARKABLE STORY OF RISK 257 (1996). Optimal portfolios are achieved by examining the historical mean volatility of an asset and its correlation to other asset. If the stock market declines, an optimally diversified portfolio will consist of asset classes that will rise in such situations.

53. The variables are the current market price of the underlying stock, the exercise price of the option, the continuously compounded risk free rate of return expressed on an annual basis, the time remaining before expiration of the option, and the volatility of the underlying stock. WILLIAM W. BRATTON, CORPORATE FINANCE 192–3 (7th ed. 2012). The Black-Scholes Pricing Model enabled any derivative security to be priced. *Id.*

54. Douglas O. Edwards, *An Unfortunate "Tail": Reconsidering Risk Management Incentives After the Financial Crisis of 2007-2009*, 81 U. COLO. L. REV. 247, 264–65 (2010).

The second prong of MPT is the Efficient Capital Markets Hypothesis ("EMH"). In 1953, an English statistician, Maurice Kendall, presented a paper to the Royal Statistical Society on the behavior of stock and commodity prices.[55] Kendall had expected to find regular price cycles, but to his surprise, they did not exist.[56] Each price change of a security seemed to wander, as if a coin was tossed.[57] In other words, price changes followed a random walk.

This means that today's price change of a stock gives investors almost no clue as to the change of a stock's price tomorrow. This does not suggest that the determinants of price changes are random, but they are determined by flows of relevant new information that arise, unrelated to past price movements.[58] If past price changes could predict future price changes, investors could make easy profits, but in a competitive market such profits don't last. When investors try to take advantage of the information in past prices of a security, its price adjusts immediately. As a result, all the information in past prices is reflected in today's stock price, not tomorrow's.[59]

EMH assumes that that in an efficient stock market, the prices of securities reflect all available information. Therefore, securities are appropriately or efficiently priced.[60] This means prices of securities reflect

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55. Maurice G. Kendall, *The Analysis of Economic Time-Series-Part I. Prices*, 117 J. OF THE ROYAL STATISTICAL SOC'Y 11 (1953).

56. BREALEY, MYERS & ALLEN, *supra* note 50, at 314.

57. *Id.* at 314–16. Remember, the odds of heads or tails on any coin flip is always 50%. Stout, *supra* note 41, at 646.

58. Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 413–14 (1970). Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575 (1991). Professor Fama was awarded the 2013 Nobel Prize for Economic Science. *See also* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

59. BREALEY, MYERS & ALLEN, *supra* note 50, at 317. In the real world there are thousands of investment analysts and millions of investors. Why would so much money be spent on trying to discover information which will yield profits when EMH posits one cannot consistently beat the market? The EMH was modified in two ways: the market price reflects the informational level of the best informed trader, and market efficiency is a matter of degree. Prices reflect the value of the firm, only if all traders have full information. BRATTON, *supra* note 53, at 24. When prices get out of line, arbitrageurs and rational investors will swoop in and make costless profits which will bring securities prices back into line. Sanford J. Grossman & George E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980).

60. Lydenberg, *supra* note 50, at 43. There are several claims about the efficiency of prices. The more modest is that prices react quickly to new information but do not necessarily relate to the intrinsic value of the firm. Prices under this view are informationally or speculatively efficient, which means that investors cannot acquire information to make advantageous purchases or sales before the information is reflected in the security's price. A stronger claim asserts that market prices react and reflect the intrinsic value of the firm. This second type of efficiency is termed "intrinsic value" or "allocative efficiency." BRATTON, *supra* note 53, at 23.

accurately the expected risk and return of those securities because securities prices incorporate the best available information about those securities.[61]

The heart of the EMH was that the market was rational and pervasive market forces invariably pushed securities' prices toward their correct, fundamental values.[62] Two conclusions follow: 1) if the EMH is correct, an individual investor or firm cannot develop an investing or trading strategy that consistently beats the market because the market price already reflects the information on which the investor acts; and 2) no investment is a *per se* bad investment because the investment's price already factors in the investment's risk.[63] Although endowments commenced investing in common stocks and reaped the benefits of bull markets, it was not until the development of MPT in the mid-1970s that, from a theoretical perspective, equities were considered a more stable investment than bonds.

III. THE NEW ENDOWMENT MODEL OF INVESTING

The core principles of MPT—that the correlation between risk and return can bring greater returns and additional risk can be managed through diversification of investments—made endowment managers more risk tolerant. Initially, portfolios shifted into equities in efficient domestic markets. Then, they moved into other asset classes and markets, some publicly traded, and others that were not.[64] Diversification became global. Endowments increased their use of derivatives, financial instruments that can hedge risk or be mere speculative wagers.[65]

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61. There is disagreement over whether prices in an efficient market are "informationally efficient" or "allocatively efficient." An informationally efficient market responds quickly to new publicly available information. Robert M. Daines & Jon D. Hanson, *The Corporate Law Paradox: The Case for Restructuring Corporate Law*, 102 YALE L.J. 577, 615 (1992). An allocatively efficient market reflects the best estimate of the present value of a firm's future earnings, that is, its intrinsic value. *Id.*

62. JUSTIN FOX, THE MYTH OF THE RATIONAL MARKET 192 (2009).

63. Sterk, *supra* note 49, at 860–61. The second conclusion means that the risk intrinsic to any marketable security is presumptively already discounted into the current price of the security. Langbein, *supra* note 43, at 649.

64. Tellus Report, *supra* note 17, at 19. There are distinctions between traditional asset classes—cash or cash equivalents, fixed income (bonds), publicly traded equities (stocks)—and nontraditional or 'alternative' asset classes, such as private equity and venture capital, hedge funds, and 'real assets' from commodities to real estate to timber. *Id.* at 19. Within asset classes, diversification means broad exposure to representative markets. *Id.*

65. Derivatives are agreements between parties that one will pay the other a sum of money that is determined by whether or not a particular event will occur in the future to some underlying financial asset, such as an asset price, interest rate, currency exchange, or almost anything else. The value of the derivative is based on the value of the underlying asset. Lynn A. Stout, *The Legal Origin of the 2008 Credit Crisis* (UCLA Sch. of Law, Law-Econ Research Paper, 2011), *available at*

Beginning in the 1990s, larger endowments, primarily those with over $1 billion in assets, undertook a new approach to portfolio management called the "endowment model of investing." This phrase describes a theory and practice of investing characterized by a highly-diversified, long-term portfolio that differs from a traditional stock/bond mix in that it includes allocations to less-traditional and less-liquid asset categories, such as private equity and real estate, as well as absolute return strategies.[66] These are called alternative investments. Basically, an alternative investment is one that is not cash, stocks, or bonds—the three traditional asset classes. "Alternate investments" is a loose phrase comprising hard assets such as minerals and timber to financial derivatives, real estate, venture capital, and private equity. They are attractive to endowments because they usually have a low correlation to traditional asset classes, which may boost overall returns. They are less regulated, transparent, and liquid than traditional asset classes, and they often have substantial minimum capital requirements and charge high fees.

The endowment model of investing tries to find two or more related assets mispriced relative to each other. Then by buying the cheap asset, selling the expensive asset, and eliminating as much ancillary risk as possible, the objective is to produce excess returns with little or no correlation to the underlying market actions. The endowment might have substantial long and short positions to capture the full potential of a small mispricing.[67]

Yale, Harvard, and other wealthy endowments became proponents of this widespread shift into alternative, arcane, and illiquid investments, which were in emerging, inefficient, and nontraditional markets.[68] The justification for this approach is explained by one of the endowment model's most successful practitioners, David F. Swenson, Chief Investment Officer of the Yale Endowment: "Alternative assets, by their very nature tend to be less efficiently priced than traditional marketable securities,

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http:ssrn.com/abstract=1770082.

66. JANE L. MENDILLO, HARVARD MANAGEMENT COMPANY ENDOWMENT REPORT, MESSAGE FROM THE CEO 3 (Sept. 2010), *available at* http://cdn.wds.harvard.edu/2010_endowment_report _09_09_2010.pdf. Absolute return strategies include short selling, futures, derivatives, arbitrage, leverage (borrowing or lending funds), and unconventional assets, similar to hedge funds. An absolute return strategy attempts to provide positive returns independent from markets' movements. YALE ENDOWMENT REPORT 2012, *supra* note 13, at 10. Absolute strategies differ from relative strategies in that the latter seek to top a benchmark, for example, the Dow Jones Industrials.

67. ANDRÉ PEROLD & ERIK STAFFORD, HARVARD MANAGEMENT COMPANY 3 (2010).

68. In 1990 Yale had 75% of its endowment in domestic marketable securities. YALE ENDOWMENT REPORT 2012, *supra* note 13, at 3. It shrank to 5.8% in 2012. *Id.* The average endowment model investment in domestic equities is 15%. 2012 NCSE, *supra* note 4, at 5.

providing an opportunity to exploit market inefficiencies through active management."[69] However, these same alternative investments may offer little transparency or liquidity, carry higher risks than traditional asset classes, and may involve speculative trading strategies.[70] For many years, the highest returns were earned by the largest endowments, which had access to the most sophisticated money managers and the in-house expertise to evaluate a complex mix of alternative investments.

IV. LEGAL RESPONSES TO THE NEW PRINCIPLES OF FINANCE

The promise of flexibility conveyed by the prudent person standard failed in application because interpretations rendered by judges and commentators were more receptive to the legal principle of *stare decisis* than to the evolving economic principles that inform investment management.[71] Trustees worried about their legal liabilities. Cary and Bright's 1969 study concluded that there was little developed law restricting the power of trustees to invest endowment funds to achieve growth, and the impediments to such freedom of action were more legendary than real.[72] However, the lack of constraining legal precedent was insufficient for institutional trustees to ignore prudence and the conservatism inherent in trust law principles.[73] Modern portfolio

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69. YALE ENDOWMENT REPORT 2010, *supra* note 12, at 9. Alternative investments include hedge funds, which traditionally were pools of capital used to purchase securities on both sides of a market risk. Today, the term connotes any lightly regulated investment pool that engages in a wide range of investment strategies, some of which are high-risk, which seek to generate superior long-term returns by exploiting market inefficiencies. Alternative investments also include private equity, such as venture capital and leveraged buyout funds, which take stakes in start-up businesses or buy firms primarily with borrowed money in the hope of cashing out at a later time when the firm is acquired by another company or goes public. The largest endowments also achieve diversification by investing in real assets, such as real estate, oil and gas, and timber.

70. Tellus Report, supra note 17, at 20. Investors demand a premium for placing assets in an illiquid investment. The illiquidity premium refers to the fact that the investment cannot quickly be converted to cash. *See* Conti-Brown, *supra* note 3, at 729. In times of financial need or extreme stress in the markets, an illiquid investment cannot be turned into cash except at a great loss or not at all. The advantage of illiquid investments is that the holder does not have to pay a liquidity premium as part of the price, thereby increasing the return on the investment. Those who may need cash in the short term cannot commit to such long term investments. From a long term perspective, this works well, but if any of the illiquid funds are needed in the present as they were in 2008 and cannot be obtained, the university will have to borrow or cut the budget or both. *Id*. at 731–32.

71. *See* Harvard Coll. v. Amory, 26 Mass. 446, 466–68 (1830).

72. CARY & BRIGHT, *supra* note 34, at 60.

73. *See* Edward C. Halbach, Jr. *Trust Investment Law in the Third Restatement*, 77 IOWA L. REV. 1151, 1153–54 (1992); Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52 (1987); JAMES J. FISHMAN

management demanded a new paradigm of prudence, which embraced modern economic theory and received unquestioned legal approval.[74]

Commencing in the late 1960s, several legislative and regulatory initiatives departed from the traditional prudence standard in defining the duties of fiduciaries of pension funds, endowments, and charities; recognized the need for diversification; permitted delegation of responsibility; and adopted modern portfolio theory.[75] In 1969, Congress enacted a restrictive enforcement regime over private foundations, which included a prohibition on jeopardy investments.[76] The Treasury regulations interpreting that section of the Internal Revenue Code accepted the principles of MPT and stated that in the exercise of the requisite standard of care and prudence, "foundation managers may take into account . . . the need for diversification within the investment portfolio."[77] The Employee Retirement Income Security Act of 1974 ("ERISA") and its regulations applicable to pension funds utilized the corporate standard of care and prudence.[78] It also adopted MPT by mandating that a fiduciary shall discharge his duties by "diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."[79]

Of particular importance to endowment managers was the adoption, eventually in forty-eight states, of the Uniform Management of Institutional Funds Act of 1972 ("UMIFA"), applicable to charitable organizations.[80] UMIFA clarified legal concerns by authorizing governing boards to invest an endowment fund with the standards of care and prudence applicable to corporate trustees.[81] It gave specific investment authority for governing boards to invest in a wide range of personal and real property,[82] and it clarified the right of nonprofits to delegate and to contract with independent financial advisors.[83] The section dealing with the standard of care was derived from the Treasury's private foundation regulations dealing with

& STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 208 (4th ed. 2010).

74. LONGSTRETH, *supra* note 22, at 152–57.

75. *Id.* at 4.

76. I.R.C. § 4944 (2012). See FISHMAN & SCHWARZ, *supra* note 73, at 794–95, for a simplified description of this complicated area of the law.

77. 26 C.F.R. § 53.4944–1(a)(2)(i) (1973).

78. Employee Retirement Income Security Act of 1974 § 404(a)(1)(B), 29 U.S.C.§ 1104(a)(1)(B) (2012); *see also* LONGSTRETH, *supra* note 22, at 32–36.

79. Employee Retirement Income Security Act § 404(a)(1)(C).

80. NAT'L CONF. ON COMM'RS OF UNIF. STATE LAWS, UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT § 2 (1972), *available at* http://www.nacua.org/documents/umifa.pdf [hereinafter UMIFA].

81. *Id.* at § 2.

82. *Id.* at § 4.

83. *Id.* at § 5.

investment responsibility of managers of private foundations.[84] UMIFA required governing boards to exercise "ordinary business care and prudence" under the facts and circumstances prevailing at the time of the action or decision.[85] Boards could consider the long and short term needs of the institution in carrying out its exempt purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.[86] The UMIFA comment to the section stated that the standard of care is comparable to the business corporate director rather than that of a private trustee.[87]

In the late 1980s and early 1990s came the drafting of uniform laws relating to trusts and the third revision of the influential Restatement of Trusts.[88] All adopted MPT and a new definition of prudent investment management. The first part of the restatement project appeared in 1992 with the publication of a volume on the prudent person rule.[89] Section 227 presented the standard of prudent investment, and the general comment to that section offered a detailed discussion of MPT as the foundation of prudent investing.[90]

In 1994, the National Conference of Commissioners on Uniform State Laws approved the Uniform Prudent Investor Act ("UPIA"), which has been adopted in forty-four states.[91] UPIA regulates the investment responsibilities of trustees of private and charitable trusts and explicitly adopted the MPT,[92] as did the Uniform Trust Code approved in 1994, which has been adopted in whole or part by twenty-five states.[93]

A revision of the UMIFA commenced in 2006. It bootstrapped upon the principles of the UPIA and was renamed the Uniform Prudent Management

84. 26 C.F.R. § 53.4944–1(a)(2)(i) (1973).

85. UMIFA, *supra* note 80, at § 6.

86. *Id.*

87. *Id.* at § 5.

88. UPIA, *supra* note 46.

89. RESTATEMENT (THIRD) OF TRUSTS: PRUDENT PERSON RULE § 227 (1992).

90. *See id*. at cmt.e (1)-p, renumbered as § 90 in 2007. Renumbered sections are used hereinafter.

91. UPIA, *supra* note 46.

92. *Id.* at § 2b. The UPIA offers a template for the process of prudent investing: (1) the standard of prudence is applied to any investment as part of a total portfolio rather than to individual investments (2) the trade-off in all investing between risk and return is a fiduciary's central consideration; (3) there are no categorical restrictions on types of investments; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of prudent investing; (4) diversification of investments is part of the definition of prudent investing; and (5) delegation of investment and management functions is specifically permitted. *Id.* at § 2(9). *See generally* Langbein, *supra* note 43.

93. UNIF. TRUST CODE § 804 cmt. (2010). The comment to this section states in part: "This section is similar to Section 2(a) of the Uniform Prudent Investor Act and Restatement (Third) of Trusts: Prudent Investor Rule § 227 (1992)." *Id.*

of Institutional Funds Act ("UPMIFA").[94] The revision has been adopted by forty-nine states,[95] and it provides a modern articulation of the prudence standards for the management and investment of charitable funds and for endowment spending.[96] UPMIFA section 3 specifically incorporates the principles of MPT and the prudence standard found in the UPIA.[97] It authorizes governing boards to invest in a wide range of personal and real property,[98] and it sets forth many of the factors a charity should take into account in making a prudent investment decision.[99] Section 3 also incorporates the general duty to diversify investments and consider the risk and return objectives of the fund.[100]

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94. UPMIFA, *supra* note 1. UPMIFA applies to charitable "institutions," a category that includes incorporated or unincorporated organizations operated exclusively for educational, religious, charitable, or other eleemosynary purposes, or government entities to the extent they hold funds exclusively for those purposes. *Id.* at § 2(4). It also applies to trusts managed by a charity. *Id.* The revisers' goal was that standards for managing and investing institutional funds should be the same regardless of whether a charity is organized as a trust, corporation, or some other entity. *Id.* at Prefactory Note. However, the rules do not apply to funds of wholly charitable or split-interest trusts (such as charitable remainder trusts) managed by a corporate or individual trustee. *Id.* In most states, those types of charitable trusts are subject to comparable rules under modern prudent investor statutes. *Id.*

95. The lone holdout is Pennsylvania.

96. The commentary to Section 3 states in part:

> Purpose and Scope of Revisions. This section adopts the prudence standard for investment decision making. The section directs directors or others responsible for managing and investing the funds of an institution to act as a prudent investor would, using a portfolio approach in making investments and considering the risk and return objectives of the fund. The section lists the factors that commonly bear on decisions in fiduciary investing and incorporates the duty to diversify investments absent a conclusion that special circumstances make a decision not to diversify reasonable.

UPMIFA, *supra* note 1, at § 3 cmt. Thus, this section follows modern portfolio theory for investment decision-making.

97. *Id.* at § 3.

98. *Id.* at § 3(e).

99. *Id.*

100. *Id.* Except as otherwise provided by a gift instrument, the following rules apply:

> (1) In managing and investing an institutional fund, the following factors, if relevant, must be considered:
>
> (A) general economic conditions;
>
> (B) the possible effect of inflation or deflation;
>
> (C) the expected tax consequences, if any, of investment decisions or strategies;
>
> (D) the role that each investment or course of action plays within the overall investment portfolio of the fund;
>
> (E) the expected total return from income and the appreciation of investments;
>
> (F) other resources of the institution;

UPMIFA's standard of care is derived from the Internal Revenue Code's private foundation regulations dealing with investment responsibility of managers of private foundations.[101] Boards must exercise "the care an ordinary prudent person in a like position would exercise" under the facts and circumstances prevailing at the time of the action or decision.[102] They may consider the long and short term needs of the institution in carrying out its exempt purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions. The commentary to the section states that the standard of care is comparable to the business corporate director rather than a private trustee. Section 5 adopts the delegation standards of UPIA section nine,[103] and it clarifies the right of nonprofit fiduciaries to delegate and to contract with independent financial advisors.[104]

UPMIFA's statement of its prudence standard attempts to straddle between the cautionary language of trust law and the more lenient attitude toward the duty of care under corporate principles, as evinced in the Model Nonprofit Corporation Act (Third).[105] The UPMIFA comment says that even though the nonprofit standard is nominally similar to the corporate standard—the words are the same—there is recognition that the entity is a

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> > (G) the needs of the institution and the fund to make distributions and to preserve capital; and
> >
> > (H) an asset's special relationship or special value, if any, to the charitable purposes of the institution.
>
> (2) Management and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution.
>
> (3) Except as otherwise provided by law other than this [act], an institution may invest in any kind of property or type of investment consistent with this section.
>
> (4) An institution shall diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification.
>
> (5) Within a reasonable time after receiving property, an institution shall make and carry out decisions concerning the retention or disposition of the property or to rebalance a portfolio, in order to bring the institutional fund into compliance with the purposes, terms, and distribution requirements of the institution as necessary to meet other circumstances of the institution and the requirements of this [act].

Id.

101. *See* 26 C.F.R. § 53.4944-1(a)(2)(i) (1973).

102. UPMIFA, *supra* note 1, at § 3(b).

103. *Id.* at §5 cmt.

104. *Id.*

105. MODEL NONPROFIT CORP. ACT § 8.30 (1987).

charity and not a business corporation.[106] Significantly, the language of section 3 dealing with the standard of conduct avoids the word "caution," which is found in the trust law equivalent.[107]

The comment adds that trust law norms already inform managers of nonprofit corporations in their decision-making, but then states that trust precedents have routinely been found to be helpful but not binding authority.[108] It may be that this language was the result of a political compromise among the drafters and interest groups. It does not offer sufficient guidance as to the standard that should be used. In light of the financial crisis' impact on endowments in 2008, if there is one guideline that is needed to remind fiduciaries of their responsibilities, it is caution.

V. CRACKS IN THE FOUNDATION OF MODERN PORTFOLIO THEORY

By the time the legal framework caught up with and endorsed the MPT, fissures had appeared in its theoretical framework. In the 1980s, empirical studies and unexpected events demonstrated anomalies that suggested the markets were not as efficient as the theory postulated.[109]

MPT assumed that risk and return could be accurately calculated, as could the covariances between them. An efficient securities market would reflect their fundamental value.[110] However, securities' market prices may not be good indicators of rationally evaluated economic value. Think of the many corporate executives and investment analysts who believe certain

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106. The standard is consistent with the business judgment standard under corporate law, *as applied to charitable institutions*. UPMIFA, *supra* note 1, at § 3.

107. *See* UNIF. TRUST CODE § 804 (2010); UPIA, *supra* note 46 § 2(a); RESTATEMENT (THIRD) OF TRUSTS § 90 (1992).

108. UPMIFA, *supra* note 1, at § 3 cmt.

109. One example is that closed-end funds trade at a discount to their fundamental value. A closed-end fund is an investment vehicle with a limited number of shares. It is closed-end because only a limited number of shares are issued and typically shares are not redeemable until the fund liquidates. Closed-end fund shares are issued in a public offering and thereafter purchased on a secondary market. In an open-end fund, the fund management creates new shares in exchange for consideration or redeems outstanding shares. The price of a share in a closed-end fund that contains publicly traded securities and pays dividends equal to the dividends on the stocks in its portfolio is valued on the basis of those dividends. BRATTON, *supra* note 53 at 15, 26, 774–75. The fundamental value of the fund is the net asset value of the securities in it divided by the number of shares in the fund. However, instead of closed-end funds trading at their fundamental value as would be expected in an efficient market, they usually trade at discounts, though occasionally they trade at a premium. These discounts cannot be explained in terms of fundamental value factors. *See* Reiner Kraakman, *Taking Discounts Seriously: The Implications of "Discounted Share Prices as an Acquisition Motive,* 88 COLUM. L. REV. 891, 902–05 (1988).

110. Fundamental value means that an asset is valued at its future cash flows and the opportunity cost of capital. If the price equals the fundamental value, the expected rate of return is the opportunity cost of capital. BREALEY, MYERS & ALLEN, *supra* note 50, at 321.

securities are underpriced or overpriced. The statement that diversification reduces risk without reducing expected return is mathematically true, assuming there exists a reliable mechanism for ascertaining the risk and expected return of individual investments. However, some scholarship questions whether market price accurately reflects risk or return.[111]

Harry Markowitz, who developed the relationship between maximizing a portfolio's expected return for a given amount of risk, never suggested that the fundamental valuation of a security was easily obtainable.[112] It may be impossible to measure whether stocks are correctly valued because no one can measure true value with precision.[113] Thus, we do not know if market levels are consistent with fundamentals (i.e. the prospects for profits or dividends). Periodically, investors exhibit an irrational exuberance which may push stock prices to an unjustifiable level. Eventually, such bubbles burst, and investors then may become unduly negative.[114]

The "dot com" bubble of 1995 until 2000 led to a NASDAQ Composite Index rise of five-hundred and eighty percent, only to decline by October 2002 by seventy-eight percent from its peak.[115] The Japanese bubble of 1985 until 1990 and the real estate bubble of the 2000s are other examples of bubbles and bursts where prices diverged from the fundamental values predicted by the EMH.[116] However, crashes have occurred without the antecedent bubble. On October 19, 1987, the New York Stock Exchange Dow Jones Index declined by over 500 points, and by the end of the month

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111. Sterk, *supra* note 49, at 868. One of the theoretical criticisms of the EMH is that it cannot be empirically tested.

> [W]e cannot test the validity of the efficient market hypothesis alone; every test of EMH also assumes some particular theory of what the 'right' price for an asset is. These asset pricing models establish the benchmark of 'normal' returns in order to determine the efficiency of the market. Consequently, every empirical test of the efficient market hypothesis is a 'joint test' of both the hypothesis and an asset pricing model. If the test yields evidence consistent with market efficiency, it also yields evidence consistent with the asset pricing model. If however, the test yields anomalous evidence, either the market is inefficient or the asset pricing model used is incorrect (or possibly both EMH and the pricing model are wrong).

Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information and Securities Research,* 60 N.Y.U. L. REV. 761, 772 (1985).

112. Markowitz, *supra* note 48, at 81 n.7 ("This paper does not consider the difficult question of how investors do (or should) form their probability beliefs").

113. BREALEY, MYERS & ALLEN, *supra* note 50, at 325.

114. *Id*. The phrase *irrational exuberance* was first used by the former chairman of the Federal Reserve, Alan Greenspan. Alan Greenspan, The Challenge of Central Banking in a Democratic Society, Remarks at Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research (Dec. 5, 1996) (transcript available at http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm#pagetop).

115. BREALEY, MYERS & ALLEN, *supra* note 50, at 325.

116. *Id.* at 325–26.

had dropped by one third, raising doubts about the theory.[117] The financial crisis of 2008 called into question the intellectual assumptions upon which modern investing is based, as well as the legal and regulatory regimes influenced by the theory.[118]

A. Evidence of Market Inefficiencies

As the MPT gained adherents, puzzling evidence emerged of anomalies in the EMH where actual prices differed from fundamental values. These anomalies concerned both short term effects and long lasting inefficiencies. Some could be explained, but others seemed inexplicable, even bizarre.[119] Empirical studies challenged the EMH assumptions,[120] leading to an

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117. BRATTON, *supra* note 53, at 39–40.

118. FINANCIAL SERVICES AUTHORITY, THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 39–47 (2009) [hereinafter TURNER REVIEW], *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf. Lord Adair Turner, who was the chairman of the U.K.'s Financial Services Authority at the time, prepared the report.

119. Empirical research discovered: 1) The January Effect: returns are higher in January than in other months and lower on Monday than on other days of the week. Most of the daily return comes at the beginning and end of the day. Because of transaction costs involving infrequent trading, this finding and others do not necessarily lead to successful trading activity; 2) The Small Firm Effect: longer term inefficiencies included stocks with the lowest market capitalizations that performed substantially better than those with the highest capitalizations; 3) The Earnings Announcement Puzzle: stock performance following the announcement of unexpectedly good or bad earnings indicated the 10% of securities with the best earnings news outperformed those with the worst news by about 1% per month over a six month period following the announcement. Investors apparently underreact to earnings announcements and become aware of the full significance only as further information arrives; 4) The New Issue Puzzle: when initial public offerings ("IPOs") come to market, investors rush to buy and receive an immediate capital gain if they sell. However, these early gains turn into losses, if the investor purchased the stock immediately following each IPO and held onto the issue for five years. From 1970 until 2007, the average annual return would have been 3.8% less than the return on a portfolio of similarly sized stocks. *Id.* at 322. These and other conclusions have been criticized or rationalized by other scholars. *Id.* at 323; 5) The Sunshine Effect: A study of stock returns in twenty-six countries found a significant positive correlation between morning sunshine and stock returns. David Hirschliefer & Tyler Shumway, *Good Day Sunshine: Stock Returns and Weather*, 58 J. FIN. 1009 (2003). Rain and snow are unrelated to stock returns. Another "mood and markets" study found that in a cross-section of thirty-nine countries using international soccer results as a primary mood variable, losses in soccer matches have an economically and statistically significant negative effect on the losing countries' stock market. For example, a loss in the World Cup elimination stage leads to a next day abnormal stock return of minus forty-nine basis points. *See* Alex Edmans, Diego Rivera & Øyvind Norly, *Sports Sentiment & Stock Returns*, 62 J. FIN. 1967 (2007).

120. Some of the other diversions from how the EMH is expected to perform include: 1) volatility: stock prices overreact to changes in fundamentals; stock price volatility over the past century appears to be too high to be attributable to new information about dividends; return volatility is greater when the market is open than when it is closed; suggesting the market makes its own news, which is not keyed to

ongoing debate over the efficiency of the markets.[121]

B. Evidence of Investor Irrationality: The Rise of Behavioral Finance

An important assumption of the EMH was that investors were rational agents and utility maximizers. Irrational investors, those who bought or sold on the basis of a hunch or other non-rational theories, were irrelevant to the market. They would be taken advantage of by arbitrageurs,[122] and their systematic losses would drive them from the market.[123]

Economics assumes investors, firms, and their managers act as if they are rational; the fields of sociology and psychology question this assumption.[124] Behavioral finance applies the teachings of psychology to the behavior of investors, focusing on experiments that have discovered

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fundamentals; 2) timing: documented patterns in stock returns over weekends, holidays and different calendar periods affect returns—returns tend to be negative on Mondays; serial correlation—over short periods of time, price changes tend to persist contradicting the random walk model; 3) contrarian investment strategies: "value" investing strategies produce high returns over time, which means that high market to book value firms are growth stocks, favored by the market earn lower returns than inexpensive "value" stocks; growth stock investors overreact optimistically to recent history of good news about those stocks; 4) sentiment: investor sentiment may explain serially correlated returns. For a description of these anomalies and citations to the literature, see BRATTON, *supra* note 53, at 25–28.

121. *See* Eugene F. Fama & Kenneth R. French, *Multi-Factor Explanations of Market Pricing Anomalies,* 51 J. FIN. 55 (1996); Burton Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59 (2003).

122. Arbitrage is a strategy that exploits market efficiencies and generates superior returns if and when prices return to their fundamental value. The arbitrageur buys an underpriced security, pushing up its price, and sells an overvalued security, pushing down that security's price. The arbitrageur's profit is the difference between the irrational price and the fundamental one. However, there are risk and trading costs. BREALEY, MYERS & ALLEN, *supra* note 50, at 327–28.

123. Gilson & Kraackman, *supra* note 58, at 583 (discussing that "market discipline in the form of heavy trading losses will restrain idiosyncratic traders and may even eliminate them through a 'Darwinian' process of natural selection"); Stout, *supra* note 41, at 665 (quoting Milton Friedman, *The Case for Flexible Exchange Rates*, in ESSAYS IN POSITIVE ECONOMICS 175 (1953)). If prices diverged from their fundamental value, arbitrageurs would exploit the price differential and drive the price back to its fundamental value. However, there may be more irrational traders than the EMH assumed, and arbitrage opportunities may be more risky and limited than initially believed. Andrei Shleifer & Lawrence H. Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP., 19, 20–23 (1990). For arbitrage trading, costs can be significant, some trades can be difficult to execute, and the market may diverge from fundamental prices before it converges, making it difficult for the arbitrageur to hold on until the market moves in the right direction. BREALEY, MYERS & ALLEN, *supra* note 50, at 327.

124. Donald C. Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture, and Ethics of Financial Risk Taking*, 96 CORNELL L. REV. 1209, 1215 (2011).

investors often acted through their personal biases in a non-rational way.[125] These investors, termed noise traders, act on the basis of their beliefs, personal experiences, the advice of their brokers or stock gurus, or chase popular trends, rather than on the basis of fundamentals.[126] Behavioral finance research suggests that irrational investors are not only a larger cohort than previously believed, but that they can affect market prices and profit over time, more than the MPT believed was possible.[127]

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125. The idea that passion rather than reason is the dominant element in human action was the view of philosopher David Hume. *See*, DAVID HUME, A TREATISE OF HUMAN NATURE 415 (L.A. Selby-Bigge & P.H. Nidditch eds., 2d ed. 1978) ("Reason is, and ought only to be the slave of the passions, and can never pretend to any other office than to serve and obey them."). See In re Oracle Derivative Litig., 824 A.2d 917, 938 (Del Ch. 2003) for a related judicial expression.

> Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. *Homo sapiens* is not merely *homo economicus.* We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values.

Id.

126. BRATTON, *supra* note 53, at 29; Shleifer & Summers, *supra* note 123, at 19.

127. Among the conclusions about investor behavior that contradict the MPT's assumptions are: 1) Loss aversion—psychological experiments discovered that people may be more loss averse than risk averse. This means that the value investors place on an outcome is affected by their fear of incurring losses. Rather than viewing the current value of their holdings for investment decision-making, they consider whether their investment has shown a gain or a loss. Daniel Kahneman and Amos Tversky's prospect theory, based on this insight, posits that the value investors place on a particular outcome is determined by the gains or losses they have incurred since the asset was acquired or the holding last reviewed. Investors are particularly averse to the possibility of even small losses and need a high return to compensate for this. BREALEY, MYERS & ALLEN, *supra* note 50, at 326. *See* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979). This translates that investors will hold on to a stock too long, rather than selling it as a rational trader would do; 2) Investors that have incurred gains are more likely to take risks. Thus, if investors are ahead in a security, they may be more prepared to take risks of losses than if they already have suffered losses in that security; 3) An incorrect estimation of probabilities. Psychologists have found that when judging the probability of future outcomes, investors look at a very small sample of similar situations and overreact to that result and project it into the future. This is termed the *Representativeness Heuristic.* For instance, an investment manager may be considered particularly skilled because he or she has beaten the market in three consecutive years. BREALEY, MYERS & ALLEN, *supra* note 50, at 326; BRATTON, *supra* note 53, at 36 (citing David Kahneman & Mark Riepe, *Aspects of Investor Psychology*, 24 J. PORTFOLIO MGMT. 52 (1998)). The investor may not acknowledge that three or five years is too short of a time frame to make an informed judgment. The legendary hedge fund manager, John Paulson, confirms this statement: In 2007 and 2008 at the height of the financial crisis, Paulson earned $20 billion for betting against subprime mortgage-backed securities and global financial firms. In 2009 he extended his winning streak by

Behavioral finance emphasizes that the limits to arbitrage and noise traders' widespread biases and hunches push prices away from their fundamental values. It delivers significant challenges to the MPT but is far from a knockout blow and remains controversial. Critics have concluded that the studies may be useful to arbitrageurs, but they offer theorists merely a prediction that securities' prices sometimes depart from informed estimates of securities' values in arbitrary and capricious ways.[128]

VI. WHAT WENT WRONG?

A. The Underestimation of Uncertainty

The MPT dealt effectively with conveying the need for management of risk but failed to adequately acknowledge the constant presence of uncertainty. It assumed the risk characteristics of financial markets could be inferred from mathematical analyses that would deliver accurate quantitative measures of trading risk. Correlations between risk and return are more difficult to value than assumed. The underlying methodological assumption was that accurate estimates can be based upon statistical analyses of past performance. There was an overreliance that past price movement patterns could deliver statistically robust inferences relating to the probability of price movements in the future.[129]

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being bullish on the stock market, and he invested in gold before the price climbed, earning for himself nearly $5 billion in 2010. Since then, one of his largest hedge funds has lost nearly 50% of its value because of mistimed investments on banks and other stocks. One of his single investments lost $500 million in 2011. *See* Gregory Zuckerman, *Suit Faults Paulson's Sino-Forest Bet*, WALL ST. J. Feb. 22, 2012, at C2; Azam Ahmed, *JAT Capital, Down 20%, Is a Lesson In Volatility*, N.Y. TIMES, July 6, 2012, at B1. Past success is no predictor of future profits; 4) Conservativeness. Individual investors tend to be too slow to update their beliefs in light of new evidence. They will eventually update their beliefs in the correct direction but the magnitude of the change is less than a rational response would mandate. BREALEY, ALLEN & MYERS, *supra* note 44, at 326; BRATTON, *supra* note 53, at 36 (citing Nicholas Barberis, Andrei & Robert Vishny, *A Model of Investor Sentiment*, 49 J. FIN. ECON. 307 (1998)); 5) Overconfidence. Investors are systematically overconfident about their investment prowess, which exaggerates the precision of their private judgments about the value of a security and underestimates the significance of public signals or the possibility of unexpected events. BREALEY, ALLEN & MYERS, *supra* note 44, at 326; BRATTON, *supra* note 53, at 36 (citing Kent Daniel, David Hirshleifer & Avanidhar Subramanyam, *Investor Psychology and Security Market Under and Overreactions*, 53 J. FIN. 1839 (1998)).

128. Stout, *supra* note 41, at 661. The classic rejoinder to behavioral finance is by Merton Miller, a Nobel Laureate in economic sciences: "That we abstract from all these stories in building our models is not because the stories are uninteresting but because they may be too interesting and thereby distract us from the pervasive market forces that should be our principal concern." Merton H. Miller, *Behavioral Rationality in Finance: The Case of Dividends*, 59 J. BUS. S451–S467 (1986).

129. TURNER REVIEW, *supra* note 118, at 1.4(iii). The models to measure risk used by financial firms, VaR or "value at risk," were flawed. Douglas O. Edwards, *An*

Probabilities based on historical data assumed normal distributions in the shape of a bell curve as one would find in the natural sciences.[130] In fact, several events in recent decades—the sudden market drop of 1987, the Long Term Capital meltdown in 1999, the "dot com" bust of 2000, and the financial crisis of 2008—underestimated the full distribution of price movements. These events lead to the conclusion that financial market movements are characterized more than ever imagined by what are known as fat-tails or black swans—events considered so rare they need not be considered as a measure of risk, but in fact occur more frequently than predicted.[131]

Though a Nobel Prize is given for economic sciences, economics and finance are very different from the certainties of the natural sciences. As Emanuel Derman, a physicist who later served as a head of quantitative analysis at Goldman Sachs, has written, "[i]n physics you're playing against God, and He doesn't change His laws very often. In finance, you're playing against God's creatures, agents who value assets based on their ephemeral opinions."[132] The belief in the mathematical rigor of statistics' ability to predict risk blinded proponents of the MPT to the constant presence of uncertainty, about which the brightest minds have warned. In Kenneth Arrow's words, "[i]t is my view that most individuals underestimate the uncertainty of the world. . . .To me our knowledge of the way things work, in society or in nature, comes trailing clouds of

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Unfortunate "Tail": Reconsidering Risk Management Incentives After The Financial Crisis of 2007–2009, 81 U. COLO. L. REV. 247, 266–67 (2010). VaR measures the potential loss in value of an asset or portfolio at a given confidence level over a specified period. To the advantage of investment professionals, it communicates risk exposure in a single dollar amount that is supposed to show how much a firm has at risk on a particular day. VaR models have come under criticism for underestimating rare or unprecedented events and for failing to consider correlations among risks or coupling of risks. Kristin Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J.L. REFORM 55 (2011).

130. A bell curve or normal distribution is tall and wide in the middle where most things measured occur and drops or flattens out at the ends or bottoms, making the whole distribution resemble a bell.

131. In finance, a fat tail refers to price movements far more variable than models of risk predicted. TURNER REVIEW, *supra* note 118, at 1.4(iii). A Black Swan is an event with the following three attributes. First, it is an outlier, as it lies outside the realm of regular expectations because nothing in the past can convincingly point to its possibility. Second, it carries an extreme impact. Third, in spite of its outlier status, human nature makes us concoct explanations for its occurrence after the fact, making it explainable and predictable. *See* NASSIM NICHOLAS TALEB, BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE xvii–xix, 141–42 (2007). The Turner Review criticizes the idea that past distribution patterns carry robust influence for the probability of future patterns of distinguishing between the world of physics, the world of the natural sciences, and the world of social sciences (such as economics). TURNER REVIEW, *supra* note 118.

132. EMANUEL DERMAN, MODELS BEHAVING BADLY: WHY CONFUSING ILLUSION WITH REALITY CAN LEAD TO DISASTER, ON WALL STREET AND IN LIFE 140 (2011).

vagueness. Vast ills have followed a belief in certainty."[133]

The MPT remains, as it should, the fundamental approach to portfolio investing. Yet, its practitioners need to be more cautious about its promises and parsimonious about its capability to manage risk in all circumstances. The MPT may only apply in certain markets involving certain securities and investments in that market. Understanding the limits of the MPT may lead to more informed policies of acceptable risk.

B. The Financial Crisis

Aside from the staggering declines in endowment values, the 2008 financial crisis presented three problems for acolytes of the endowment model of investing: 1) insufficient liquidity existed for endowments to contribute to annual budgetary obligations at the same dollar level, which impacted normal operations and undermined one of the rationalizations for massive endowments; 2) increased collateral obligations to hedge funds and private equity partners mandated investing additional resources, thereby exacerbating endowments' liquidity problems;[134] and 3) a lack of resources to pursue newly cheap investment opportunities.

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133. Kenneth J. Arrow, *I Know a Hawk from a Handsaw*, *in* EMINENT ECONOMISTS: THEIR LIFE PHILOSOPHIES 46 (Michael Szenberg ed. 1992). Professor Arrow received the 1972 Nobel Prize in Economic Sciences. The ongoing presence of uncertainty with regularity was expressed in 1703 by the great mathematician Gottfried Liebnitz: "Nature has established patterns originating in the return of events, but only for the most part." BERNSTEIN, *supra* note 52, at 329.

This has been echoed by John Maynard Keynes, who wrote:

> If we speak frankly, we have to admit that our basis of knowledge for estimating the yield ten years hence of a railway, a copper mine, a textile factory, the good will of a patent medicine, an Atlantic liner, a building in the City of London amounts to little and sometimes to nothing; or even five years hence . . . Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic. Most probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits—of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities . . . We are merely reminding ourselves that human decisions affecting the future, whether personal or political or economic, cannot depend on strict mathematical expectation, since the basis for making such calculations does not exist; and that it is our innate urge to activity which makes the wheels go round, our rational selves choosing between the alternatives as best we are able, calculating where we can, but often falling back for our motive or whim or sentiment or chance.

JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, & MONEY 149–50, 161–66 (1936).

134. Many of the illiquid investments contained options by the counterparty to call for additional funds from college and university investors.

Alternative investments' illiquidity and volatility increased losses in 2008, affecting results of the fiscal year 2009. The alternative investments were difficult to unload. Prices offered in secondary markets were so low that major college and university endowments pulled back from selling.[135] Proponents of the endowment model of investing correctly point out that even with such losses, the long term returns were greater than if the endowments remained invested in equities and bonds. This justification, however, ignores the impact of the losses on college and university programs and on its constituencies and the wider community.

During this period, colleges, universities, and other charities largely ignored the theoretical justifications for their endowments—spending more to smooth out flows of revenue in lean years and ensuring intergenerational equity for today's students.[136] Peter Conti-Brown posits a trade-off between additional spending and selling assets to increase liquidity and reducing the annual budget contribution of the endowment. Colleges and universities took the latter course of cutting budgets, firing staff, and deferring new projects, which disrupted essential college and university functions.[137] Harvard, which in recent history has competed with Yale and Stanford for first place in the endowment performance derby, offers a cautionary tale of the dangers of excessive risk and illiquidity. It invested a huge amount in swaps, financial instruments that lock in interest rates, with the expectation that rates would rise in the future when the University would borrow heavily to build its new Allston campus.[138] After the financial markets unexpectedly collapsed in 2007, central banks reduced some bank lending

135. Harvard unsuccessfully attempted to sell $1.5 billion in private-equity stakes on the secondary market in fall 2008. It then made a $2.5 billion bond offering to cover swaps agreements that were wagers that interest rates would rise, when Harvard build its Allston campus. When rates fell to near zero, Harvard had to pay a margin call on $1 billion to large banks. The University paid approximately $100 million to unwind swaps related to hundreds of millions of dollars in variable rate borrowings. The ultimate cost to the University was $1.8 billion. *See* Conti-Brown, *supra* note 3, at 733–35; Michael McDonald, John Lauerman & Gillian Wee, *Harvard Swaps Are So Toxic Even Summers Won't Explain*, BLOOMBERG (Dec. 18, 2009, 4:28 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid =aHQ2Xh55jI.Q; Tellus Report, *supra* note 17, at 37–38. Other colleges and universities found themselves in similar situations, though not quite of the same scale.

136. *See* Conti-Brown, *supra* note 3, at 2–3. A few nonprofit institutions such as the New York City Opera tapped into their endowments to cover enormous budget deficits. This provided temporary relief but ultimately did not save the organization. *See* James B. Stewart, *A Ransacked Endowment at New York City Opera*, N.Y. Times, Oct. 12, 2013, at B1; Daniel J. Wakin, *New York City Opera to Leave Lincoln Center*, N.Y. TIMES, May 21, 2011, at A1; Daniel J. Wakin, *City Opera Taps Into Endowment*, N.Y. TIMES, April 18, 2009, at C2.

137. Conti-Brown observes that the financial crisis may have given college and university administrators the opportunity to cut into areas that were justified, but which in the good years were politically impossible. Conti-Brown, *supra* note 3, at 740.

138. McDonald, Lauerman & Wee, *supra* note 135.

rates to zero. This meant the value of the swaps declined and as part of its swaps agreements, Harvard had to post approximately $1 billion in collateral.[139] To a lesser extent, other schools were in the same position. Private equity investments often have future call commitments, which require investors to put up additional funds upon request. Were the possibilities of private equity calls and posting additional swaps collateral factored into the risk models? Or were the risk models inaccurate?

As the endowment sunk, Harvard's cash account declined sharply. The University did what individuals do when they need cash—they borrowed—$2.5 billion, of which nearly $500 million was used to terminate the swaps agreements.[140] Harvard's problems were exacerbated by the percentage of the endowment allocated to illiquid assets. Even the cash account, normally invested conservatively in short-term commercial paper and money market funds, had been eighty percent invested along with the endowment, which was an extremely risky move. The impact on the university was substantial. Capital spending was cut in half, and the building of the new campus postponed. There were layoffs, closure of libraries, pay freezes, and budget cuts.[141] Endowment performance in 2008 and administrators' responses called into question the new endowment model, though few universities jettisoned it.[142]

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139. *Id.*

140. *Id.*

141. *See* Stephanie Strom, *Nonprofits Paying Price For Gamble on Finances*, N.Y. TIMES, Sept. 24, 2009, at A16; Beth Healy, *Harvard Ignored Warnings about Investments*, BOSTON GLOBE (Nov. 29, 2009), http://www.boston.com/news/local/massachusetts/articles/2009/11/29/harvard_ignored_warnings_about_investments/; McDonald, Lauerman & Wee, *supra* note 135.

Other large endowment institutions were similarly affected. Stanford University intended to sell $5 billion of illiquid assets to raise cash but later pulled back because the markets improved or the offers were too low. Craig Karmin and Peter Lattman, *Stanford Pulls Asset Sales Off Auction Block*, WALL ST. J., Dec. 15, 2009, at C1. Yale University reduced staff, froze salaries for deans and officers, reduced the number of graduate students, and turned down the heat to sixty-eight degrees in order to close a $150 million budget deficit. Lisa W. Foderaro, *Yale, With $150 Million Deficit, Plans Staff and Research Cuts*, N.Y. TIMES, Feb.4, 2010, at A28. Cornell laid off 150 staff and another 432 took early retirement. Princeton University eliminated forty-three positions in order to reduce its operating budget by $170 million over two years. *See infra* Appendix I. Despite the recovery of Harvard's endowment, the cutbacks have remained. *See* Jennifer Levitz, *Economy Tests Harvard*, WALL ST. J., July 31, 2012, at A3. In the fiscal year 2012, Harvard paid $345.3 million in terminating interest rate swaps, bringing the cost of unwinding debt derivatives to more than $1.25 billion. John Lauerman & Michael McDonald, *Harvard University Lost $US345.3 Million Terminating Interest-Rate Sawps*, BLOOMBERG (Nov. 8, 2013, 8:38 PM), http://www.bloomberg.com/news/2013-11-08/harvard-swap-toll-tops-1-4-billion-ending-deals-in-2012-2013.html ("Harvard University, the world's richest college, lost $345.3 million terminating interest-rate swaps last year, bringing its cost of unwinding debt derivatives since 2008 to more than $US1.25 billion.").

142. Conti-Brown, *supra* note 3, at 731; Tellus Report, *supra* note 17, at 22–24.

C. Second Tier Endowments

Colleges and universities with endowments less than $1 billion used a modified form of the endowment model of investing, which in the good years did not achieve as high returns as the largest proponents of the model. They were unable to invest in some particularly successful hedge funds because the minimum capital accepted was beyond their means, or they would skew their portfolio allocations by placing too great a percent of their portfolio in illiquid assets with unacceptable levels of volatility. Some private equity investments may have been closed to them, or the endowment was unwilling or unable to tie up so much money for long periods and be subject to calls for more capital.

Often, they utilized investment pools such as Commonfund, an endowment manager for nearly 1,500 institutions offering a variety of funds of differing risk,[143] or The Investment Fund for Foundations, which offers charities access to a diverse group of asset classes at relatively low cost.[144] These endowments did not have the capacity themselves to evaluate outside investment managers so they retained outside experts, such as the Commonfund or others, to vet investment possibilities. All but the largest endowments have private consulting firms or supervisors of investment managers to monitor and steer assets into approved investment vehicles. This is not free advice, so returns may be reduced. Some endowments invested in so-called funds of funds, which also lowered possible returns.[145]

D. Oversight Problems and Lack of Understanding of Investments

Problems using the new endowment model of investing emerged even before the financial crisis. Although UPMIFA and UPIA encourage a delegation of investment management, a nonprofit board cannot thereafter abdicate its responsibility to monitor the delegates and to understand the nature of the investment strategy.[146] Several universities failed in this regard. The University of Minnesota System and the University of Minnesota Foundation reached an out-of-court settlement with a money

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But see William Jarvis, *Is the Endowment Model Still Working?*, 18 TRUSTEESHIP 20 (Mar.-Apr. 2010). Data in NACUBO-Commonfund Study of Endowments in 2010 did not show a turning away from the endowment model, which still was able to deliver around 270 basis points per year of extra value.

143. *About Us*, COMMONFUND (Apr. 4, 2014, 10:17 PM), http://www.commonfund.org/ABOUTUS/Pages/default.aspx.

144. *See* LUIS M. VICEIRA & BRENDON C. PARRY, THE INVESTMENT FUND FOR FOUNDATIONS (TIFF) IN 2009 (2010).

145. A Fund of Funds (FOF) invests in other hedge and private equity, providing added diversification along with double fees, those of the underlying funds, and of the FOF.

146. UPMIFA, *supra* note 1, at § 5(3) (2006); UPIA, *supra* note 46, at § 9(a)(3) (1994).

management firm because the firm failed to inform officials at the University of the risks involved in trading derivative instruments invested on the University's behalf.[147] DePauw University sued an investment advisory firm and its principals alleging that they failed to thoroughly investigate the hedge funds they recommended and misrepresented facts about them.[148] Because of bad investments into alternative investments, poor investment advice, and a seeming ignorance of the benefits of diversification of endowment assets, Cooper Union ended a 110-year "no tuition" policy and was forced to charge its students $20,000 tuition.[149]

The 2008 financial crisis exposed gaps in trustee oversight and generated litigation from charities claiming they were misled into investing in vehicles that were much riskier than imagined or illiquid. The University of Pittsburgh and Carnegie Mellon University lost the $114 million they invested in Westridge Capital Management, a firm run by two individuals accused of using the firm as a personal piggy bank.[150] It had been vetted with approval by consulting firms.[151] The universities had relied on the recommendation of an outside investment consultant and were lured by the promise of big returns on alternative investments.[152]

E. Lessons Learned and Unlearned

The lessons of behavioral finance and the unexpected events of recent years pose challenges to the application of the MPT but do not eliminate it as the fundamental method for endowment investment. They do raise important signals concerning the need for caution and an increased appreciation of risk for endowment investing strategies. The answer to the

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147. Kim Strosnider, *Settlement Reached at University of Minnesota*, CHRON. HIGHER EDUC., Nov. 28, 1997, at A42.

148. The University had invested $3.25 million in one of the Bayou Group's hedge funds. Bayou fabricated its returns and collapsed in 2005. *See* Ian McDonald, *Clients Are Suing Hennessee Group Over Bayou Advice*, WALL ST. J., Oct. 15–16, 2005, at B6. The collapse also ensnared the Christian Brothers School of Nashville, which had invested $1.2 million. The bankruptcy trustee was successful in clawing back the redemption of that investment because the school was on notice when it redeemed that something was wrong at the fund. *See In re* Bayou Group, 396 B.R. 810 (Bankr. S.D.N.Y. 2008).

149. James B. Stewart, *How Errors in Investing Cost a College Its Legacy*, N.Y. TIMES, May 11, 2013, at B1.

150. *See* Paul Fain, *2 Universities Seek Answers After $114-Million Vanishes in an Alleged Swindle*, CHRON. HIGHER EDUC. (Mar. 5, 2009), http://chronicle.com/article/ 2-Universities-Seek-Answers/1565/. Carnegie Mellon eventually received more than $40-million in restitution. Andrew Mytelka, *Carnegie Mellon U. Gets $40-Million Returned from Investment Swindle*, CHRON. HIGHER EDUC. (Apr. 22, 2011), http://chronicle.com/blogs/ticker/carnegie-mellon-u-gets-40-million-returned-from-investment-swindle/32389.

151. Tellus Report, *supra* note 17, at 24.

152. *See* Fain, *supra* note 150; Mytelka, *supra* note 150.

question, "what went wrong?" is the under appreciation of risk and the overconfidence in the ability to manage it. The MPT may only apply in certain markets involving particular securities.

We are living in a period of financial turbulence. Investors and markets have underestimated the probability of extreme volatility. Risk is greater and more unpredictable than the MPT posits. The MPT presumed that future volatility would replicate the present and the past, but recent events have shown that is not so, at least in the probabilities expected. In periods of great volatility and economic upheaval, covariance changes are much greater and much more unpredictable than normal. The rational actions of investors in normal times can collectively become irrational.[153] Many investment vehicles used in endowment portfolios are opaque, illiquid, and incapable of adequate analyses of the risk, the probabilities of return, or the relationship between the two.

The high returns initially generated by the endowment model of investing disguised the limits of the MPT's risk management techniques. The elegance of the theory encouraged people to believe more than it actually promised. The endowment model led to investments in markets and financial products where neither variance nor expected earnings could be derived with any degree of confidence. Harry Markowitz, the discoverer of the relationship between risk and return, seems to have stepped back from the extension of the theory into private placements commodities and beyond, "[t]hese assets . . . must be properly valued and thus, are best left to people like Warren Buffet or David Swenson."[154]

Even after the harsh lessons of 2008, prudence and humility are in short supply by investment committees and their advisors. Despite the sobering experience of the financial crisis, large and small endowments invested *more heavily* in illiquid alternative investments in an effort to squeeze additional returns from the low interest rate environment.[155] However, because of the strength of the equity markets in 2013, college and university endowments have cut their alternative investment allocations.[156]

In uncertain times, endowment investment policies should reflect a

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153. RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 112 (2009).

154. Alan Lavine, *Harry Markowitz Father of Modern Portfolio Still Diversified*, 101 FIN. HIST. 17, 19 (Fall 2011).

155. 2012 NCSE, *supra* note "4, at 6.

156. In the fiscal year 2013, the average allocation in alternative investments fell from 54% to 47%. NAT. ASS'N OF COLL. AND UNIV. BUS. OFFICERS, 2013 NACUBO-COMMUNFUND STUDY OF ENDOWMENTS (2013) [hereinafter 2013 NCSE]. Yale reduced its private equity exposure to 31% for the fiscal year 2014 from 35.3 in 2012, the first reduction in that investment class since 2005. Michael McDonald, *Colleges Cut Alternative Investments to Recoup Losses*, BLOOMBERG (Nov. 6, 2013), http://www.bloomberg. com/news/2013-11-06/colleges-cut-alternative-investments-to-recoup-losses.html.

heightened element of caution and prudence into the investing equation. Given the composition and dynamics of college and university boards, this may be difficult to achieve.

VII. GOVERNING BOARD OVERSIGHT OF INVESTMENT POLICY

Ultimately, the governing body is responsible for monitoring an institution's endowment. While it is difficult to generalize about the composition of college and university boards, one can suggest that they primarily are made up of successful alumni involved in business activity, prominent individuals who have supported the institution, plus others who give representation to some of the college or university's constituencies. Several trustees are likely to be involved in financial services, but that does not mean in and of itself they are knowledgeable about investment strategy or risk management.

A. Organizational Structures for Managing Endowments

The organizational structures for managing endowments differ. One approach is the self-standing management company with a separate board of trustees appointed by the college or university's governing board and including some overlap of membership between the managing company's board and the college or university's governing body. Examples of this approach include Duke (DUMAC), Harvard (Harvard Management Company), and Stanford (Stanford Management Company). The management company's board is responsible for asset allocation decisions and supervision of the management company. The college or university's governing board ultimately controls the management company and determines annual endowment spending rates.[157] Another model is for the governing board's investment committee to oversee the committee or investment office that manages the endowment.[158]

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157. Princeton illustrates this approach. Princo, the University's management company, serves as the manager of over one hundred external financial managers of hedge funds, private equity companies, real estate, and alternative investments. Princo's board of directors determines how assets are to be allocated among major investment categories. The twelve member board includes members of the Committee on Finance of Princeton's Board of Trustees. The Committee on Finance approves the annual endowment spending rate and has an annual joint meeting with Princo's Board. PRINCETON UNIV. OFFICE OF FINANCE AND TREASURY, ENDOWMENT 101 7 (2011), *available at* www.princeton.edu/vpsec/cpuc/. . ./2-23-2012-meeting-summary.pdf.

158. Brown, Cornell, Michigan, Penn, and Texas among many others follow this approach. At Yale, the Yale Corporation Investment Committee is responsible for oversight of the endowment and portfolio policy formulation. The Investment Committee consists of at least three Fellows of the Corporation and other persons with particular investment expertise. The Committee meets quarterly, at which time members review asset allocation policies, endowment performance, and strategies proposed by investments office staff. The Committee approves guidelines for

Most colleges and universities rely on external managers, such as Commonfund or The Investment Fund for Foundations, to invest ninety-five to one hundred percent of their endowments.[159] This figure implies that most endowments are passively invested with investment committees determining overall strategy or reaffirming the recommendations of the chief investment officer. The largest endowments monitor more directly the external managers of endowment assets, the hedge funds, and private equity firms.[160] The board or its investment committee will select an asset allocation approach that satisfies the institution's appetite for risk. The external investment advisory firm may manage some funds in which the endowment directly invests, or it may serve as an adviser and monitor of hedge funds and other asset vehicles making investment recommendations for the particular endowment.

Harvard, through the Harvard Management Company, has a unique hybrid approach. It directly manages approximately one-third of its endowment assets internally, a higher percentage by far than other endowments. The remainder is handled by third party managers. Harvard maintains that its approach is more cost effective, leading to greater returns for the endowment.[161]

B. Investment Committees

Most endowments are monitored by an investment or finance committee, composed of individuals experienced in finance and successful in that field. They have the skill set to work with college and university endowment staff and outside investment advisers and managers. An investment

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investment of the Endowment portfolio, specifying investment objectives, spending policy, and approaches for the investment of each asset category. THE YALE ENDOWMENT 2011 27 (2011) [hereinafter YALE ENDOWMENT REPORT 2011], *available at* http://www.yale.edu/investments/ Endowment_Update.pdf.

159. The 2012 NCSE study reported that the 823 institutions surveyed employed an average 1.6 full-time equivalent employees to manage their endowments. 2013 NCSE, *supra* note 4. An outside consultant is used to manage the endowment by 81% of the responding institutions. *Id.*

160. A major staff responsibility at Yale's Investment Office is finding and working with high quality external managers, or as it terms them, "partners." The Investments Office's staff meets with many prospective investment managers each year. It then eliminates most candidates and conducts numerous layers of due diligence on compelling candidates. Yale chooses to partner with managers with whom the University can develop long-lasting relationships. The average manager tenure in Yale's portfolio is eleven years. YALE ENDOWMENT REPORT 2011, *supra* note 158, at 19.

161. HARVARD MANAGEMENT CO., A UNIQUE INVESTMENT MODEL (2010), *available at* http://www.hmc.harvard.edu/.investment-management/hybrid_model.html. In 2010, the Harvard Management Company had an annual operating budget of $67 million and employed approximately 180 people, including 40 investment professionals. Perold & Stafford, *supra* note 67.

committee should bring discipline to the endowment management process by reviewing staff or external managers' investment recommendations, but its ultimate authority yields to staff expertise. The investment committee manages the process, not the portfolio.[162] Their monitoring is supportive, passive, if not nominal. They are likely to have a similar mindset with staff or external managers.

The investment committee or its equivalent drives board discussions of endowment policy. These individuals' expertise contrasts with other board members and engenders a respect in their views by the latter. Investment professionals are likely to be self-confident individuals with a high level of self-esteem. They may exhibit a greater willingness to take and tolerate risk, believing in their ability to understand and control it, thereby underestimating its threat.[163]

Over-optimism is a common trait in the world of finance, particularly among successful and intelligent investment professionals. Such individuals are confident of their ability to navigate the financial markets. Successful risk-taking led to extraordinary endowment growth in the 1990s, when double-digit increments became the norm in the largest endowments and encouraged increased risk taking among their smaller brethren. This fed into an optimistic risk culture with a payoff of great rewards for the endowment and for its investment advisers and managers.[164] Investment committees became risk complacent. They may

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162. The Yale Endowment Report describes the relationship between the investment committee and staff:

> Ideally, committees rarely exercise the power to reject staff recommendations. If a committee frequently turns down or revises investment proposals, the staff encounters difficulty in managing the portfolio. Investment opportunities often require negotiation of commitments subject to board approval. If the board withholds approval with any degree of regularity, staff loses credibility in the eyes of the investment management community. That said, the committee must provide more than a rubber stamp for staff recommendations.

YALE ENDOWMENT REPORT 2011, *supra* note 158, at 27. Thus, the investment committee is allied with endowment staff.

163. Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals about Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285–304 (2004). Recent events involving the supposedly best-managed American bank, JPMorganChase, show that excessive risk taking, lax controls, and inaccurate risk models remain alive and active on Wall Street, and this should provide a cautionary tale to college and university trustees. *See* Jessica Silver-Greenberg & Susanne Craig, *JPMorgan Trading Loss May Reach $9 Billion*, N.Y. TIMES (June 28, 2012), http://dealbook.nytimes.com/2012/06/28/ jpmorgan-trading-loss-may-reach-9-billion/?_php=true&_type=blogs&_r=0; Nelson D. Schwartz & Jessica Silver-Greenberg, *JPMorgan Was Warned about Lax Risk Controls*, N.Y. TIMES, June 4, 2012, at B1; Julie Steinberg and Dan Fitzpatrick, *J.P. Morgan Models Get Regulatory Spotlight*, WALL ST. J., June 29, 2012, at C1.

164. Langevoort, *supra* note 124, at 1219–20. Investment advisers at endowments are often paid for performance, receiving bonuses for exceeding benchmarks. This

have been unduly influenced by their endowment's returns, compared with similarly situated competitors. The endowment derby overshadowed the twin endowment missions of stability and intergenerational equity and reinforced risk tolerance.[165]

C. Board Cohesion

A substantial body of literature views boards as complex social units, subject to the same social and psychological influences that affect such groups generally.[166] To work effectively, boards prefer consensus, approval, and group solidarity. A leading criterion for board service is the individual's identification and acceptance of the organization's goals and methods of operation.[167] Most college and university governing board members are alumni and share the status rewards and prestige such service brings. They may have professional or personal relationships among themselves. Cohesive boards often come from the similar social and economic milieus. This is not to suggest that board personalities and their internal dynamics do not vastly differ, but various social influences shape board behavior and deliberation.[168]

D. Deference in Decision-making

The pressures of cohesion make board oversight of endowment policy difficult. The endowment model of investing is complex, if not unfathomable to the uninitiated.[169] Because of a substantial knowledge

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method of compensation encourages risk taking as it does at hedge funds and investment banks.

165. Conti-Brown, *supra* note 3, at 736–37, 740.

166. Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, And The Unintended Consequences of Independence And Accountability*, 89 GEO.L.J. 797, 810. (2001).

167. James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 L. & CONTEMP. PROB. 83, 91 (1985). Another important consideration is compatibility with other board members. Selection practices promote cooperation, consensus, and uniformity of view. *Id.* at 91–92.

168. Social influence refers to the phenomenon that individuals tend to conform their conduct to that of other individuals. Dan M. Kahan, *Social Influence, Social Meaning and Deterrence*, 83 VA. L. REV. 349, 362 (1997). Social influence shapes values. Individuals tend to adapt their convictions to those of their peers. Such adaption can occur rapidly once individuals are exposed to information about their peers' attitudes. *Id.* at 358–59. This has also been termed structural bias where members of a board or group are favorably disposed to each other. *See* Nicola Faith Sharpe, *Process Over Structure: An Organizational Behavior Approach to Improving Corporate Boards*, 85 S. CAL. L. REV. 261, 286 (2012). *See also* Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 824–25 (2004).

169. The complexity and quantification of investment analysis hinders disclosure and obscures explanation and consequences (i.e. risk) even to experts; *See generally*

deficit, it is difficult for board members unfamiliar with finance to pose questions about endowment policy. In a sense, in the matter of endowment investing policy, boards may be captured by the investment committee and the investment advisers.

Boards exhibiting a high degree of cohesion are likely to think alike. Such groups may be subject to a subconscious censorship of diverging opinions or viewpoints counter to the majority. Directors with financial expertise receive undue deference from other board members, which results in deliberations that may be empty formulaic approvals without adequate deliberation of alternative approaches.[170] Investment policy is complex, and informational asymmetries between non-financial services board members and investment professionals compound the problem of chilling dissent.[171] Non-expert directors need assistance in interpreting investment and risk policy, which they may not receive, and even if they do, they may not understand the information. A rising endowment may quiet any board concerns hiding the risk level of the endowment, particularly amongst trustees without financial expertise.

A college or university board needs to develop a culture of oversight of investment strategy that involves the full board and not merely the investment committee. Ideally, boards should have members experienced in risk management. That, however, is unlikely to occur.[172]

VIII. IMPROVING BOARD OVERSIGHT OF ENDOWMENT RISK

Risk oversight should be a governance responsibility of the board. It consists of the process of reviewing, assessing, and categorizing various types of risk to which an endowment and the institution are exposed.[173]

Steven Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 221–25 (2009) (discussing how complexity of modern investment securities can hinder disclosure and conceal consequences).

170. This has been termed "group think," where directors place allegiance to fellow board members ahead of the organization's best interests, undermining social norms that facilitate sound governance procedures. Melanie Leslie, *The Wisdom of Crowds? Groupthink and Nonprofit Governance*, 62 FLA. L. REV. 1179 (2010). It has also been called "herding behavior." Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 28–29, 32 (2002) (finding that the desire to maintain group cohesion trumps the exercise of critical judgment).

171. Leslie, *supra* note 170, at 1197.

172. The absence of board members knowledgeable about risk management is not limited to college and university endowments, but played a role in financial institutions that collapsed or needed to be bailed out during the financial crisis. *See* Paul Strebel, *Time to bring real shareholders back on board*, FIN. TIMES (Feb. 12, 2009), http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/future-envir-O-0902.pdf.

173. Risk management involves more than the financial risk of an endowment imploding. It includes ensuring that systems are in place to protect against occurrences

College and university boards should follow their corporate counterparts by giving risk oversight a higher profile in the governance portfolio.

The best way to involve the full governing board in evaluating the endowment's risk policy would be to create a board level Risk Oversight Committee ("ROC"). This approach to foreseeing and managing risk is mandated for large bank holding companies and other covered companies under the Dodd-Frank Act,[174] and it is recommended by the Walker Report which reviewed corporate governance in U.K. banks and other financial institutions.[175] It offers a possible template for college and university boards, for what is a college or university endowment but the institution's in-house bank?

Colleges and universities are increasingly complicated institutions and face a number of types of risk, of which endowment volatility is but one. The NACUBO-Commonfund Study of Endowments (NCSE) 2013 preliminary data shows that even after the events of 2008, colleges and universities seem not very concerned with endowment risk.[176] For the first time, the NCSE 2013 survey will publish information about risk oversight

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that put the institution's reputation in peril as well as strategic planning on how to deal with such events. For example, planning on how to prevent and respond to catastrophic events that may damage the institution: scandals, shootings, fires, and similar tragedies. There is an overlap obviously with the audit functions of installing reporting systems, but risk oversight would include crisis management scenarios. This article deals with financial risks, but recognizes that is but one part of the risk oversight portfolio.

174. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165(3), 124 Stat. 1375, 1423–32 (2010) (codified at 12 U.S.C. § 5365) [hereinafter Dodd-Frank Act]. See Dodd-Frank Act § 165(b)(1)(A)(iii) for the risk management standards. On December 11, 2011, the Federal Reserve Board requested comments on a proposed rule to implement the requirements of § 165. *See* Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies: Proposed Rules Request for Comments, 77 Fed. Reg. 594-663 (Jan. 5, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf. The New York Stock Exchange requires listed companies to provide disclosure about their risk oversight practices including information about the board's role in managing risk. *See* N.Y. Stock Exchange Listed Companies Manual § 303A.07(b)(i)(1).

175. DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN U.K. BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES (2009), *available at* http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf.. Recommendations twenty-three through twenty-seven deal with the governance of risk. *Id.* at 19–20. The report recommended that banks or life insurance companies should establish a board risk committee separate from the audit committee, which should have responsibility for oversight and advice to the board on current risk exposures of the entity and future risk strategy. *Id.* at 19. The board should have a chief risk officer, who would participate at the highest level on an enterprise-wide basis and report to the board risk committee. *Id.* The risk committee's activities should be included as a separate report within the annual report. *Id.* at 20.

176. NAT'L ASS'N OF COLL. AND UNIV. BUS. OFFICERS, 2013 NCSE PRELIMINARY RELEASE (2013), *available at* http://www.nacubo.org/Documents/research/2013NCSEPreliminaryPressRelease.pdf [hereinafter 2013 NCSE Preliminary Release].

by endowments.[177] The preliminary data indicates that forty-five percent of participating institutions employ risk limits on their portfolio, while thirty-three percent do not.[178] Sixty-nine percent of those using risk limits use volatility calculations, and fifty-four percent use measures such as alpha/beta analysis; thirty-nine percent use stress testing or scenario analysis.[179] These are surprisingly low figures, indicating that when boards delegate their endowment investment strategy to outside managers, many do not oversee the risks in their portfolios beyond making a decision on allocation of investment classes.[180]

Endowment risk oversight is not usually carried out by a separate board committee; rather, it is delegated to one of the existing standing committees: investment, finance, or more likely, audit. There is debate in the corporate world whether financial risk functions should reside in the audit committee's portfolio. An initial question is whether the audit committee has the time, the skills, and the support to accomplish the job effectively, given its other substantial responsibilities.[181] In a sense, auditing differs from risk oversight in that the former deals with past activities and the latter focuses on future events—i.e. how to channel and protect against the occurrence of unwanted possibilities and to strategize how to deal with such events.

The actual calculation of endowment risk is conducted by risk managers, who may be a part of a risk-management department or group within the college or university's investment management company or its external investment advisors. Risk managers assess and measure the risks facing an institution as a result of its investing activities, monitor the risks for change, determine whether the institution has the resources to deal with the risk, and alert senior management and the board about risk issues.[182]

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177. *Id.*

178. *Id.* at 4.

179. *Id.*

180. For an excellent introduction to risk management and its failures in financial institutions leading to the 2008 financial crisis, see James Fanto, *Anticipating the Unthinkable: The Adequacy of Risk Management in Finance and Environmental Studies*, 44 WAKE FOREST L. REV. 731, 735–36 (2009). *See infra*, note 182 for definitions of some methods for evaluating endowment risk.

181. The Conference Board's experience is that corporations that lodge risk oversight in the audit committee have vastly differing views of what that responsibility entails and their scope is all over the map. Additionally, the "audit committee financial expert," mandated by Sarbanes-Oxley, may not have the skills necessary for evaluating and assessing risk. CAROL BEAUMIER & JIM DELOACH, RISK OVERSIGHT: SHOULD YOUR BOARD HAVE A SEPARATE RISK COMMITTEE? (2012), *available at* http://www.conference-board.org/retrievefile.cfm?filename=TCB-DN-V4N1-12.pdf&type=subsite.

182. *See* Fanto, *supra* note 180, at 735–36. Financial risk assessment includes both quantitative and qualitative analyses. Quantitative tools use models based on statistical measures to quantify the possibilities of loss based on past investments and financial

Whichever board committee is responsible for risk oversight, it should understand and identify all risks facing the institution, ensure that appropriate limits are in place for financial investments, and evaluate the institution's risk management framework, compliance limits, and reporting systems. It should attempt to protect the institution against catastrophic loss, prepare for minimizing such losses, and evaluate the impact of such losses on the institution's constituencies.[183] If a board level risk oversight committee is created, it might develop policies and parameters for investing in particularly risky vehicles, which would be approved by the full board. As with other board committees, the ROC would work closely with external risk management firms retained to advise the committee.[184]

CONCLUSION

Decisions concerning a prudent or suitable level of risk for a particular endowment should be reached only after thoughtful consideration of the fund's purposes and the institution's tolerance of volatility of return. The

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exposures. The most common is value at risk ("VaR"), which produces an approximation of worst case scenarios by assessing at different confidence degrees the minimum values of assets in the future. VaR provides an estimate of how much can be lost in a single day. Nizan Geslevich Packin, *It's (Not) All About The Money: Using Behavioral Economics to Improve Regulation of Risk Management in Financial Institutions*, 15 U. PA. J. BUS. L. 419, 435–36 (2013). A problem with VaR is that it is based on historical data about past investment performance and the assumption that future deviations will follow a bell curve distribution. As with all quantitative approaches, the quality of the inputted data affects the quality of the output. *See* generally Edwards, *supra* note 129; Johnson, *supra* note 129.

Other techniques of risk assessment are stress testing and scenario analysis, which have a more qualitative focus because they assess potential losses caused by adverse situations and evaluate how the endowment would respond. Fanto, *supra* note 180, at 737. Stress testing is a procedure for evaluating the potential loss of a portfolio due to underlying risk factors over a wide range of scenarios of risk, including those of very low probability. Scenario analysis analyzes future events that result in a wide variety of outcomes that would be unfavorable to the endowment's value. Essentially, stress testing and scenario analysis are forward-looking economic assessments that evaluate whether the institution, in this case an endowment, is strong enough to endure difficult economic conditions. Patkin, *supra* note 182, at 479. *See* BASEL COMM. ON BANKING SUPERVISION, PRINCIPLES FOR SOUND STRESS TESTING PRACTICES AND SUPERVISION 9–11 (2009), *available at* http:// www.bis.org/publ/bcbs147.pdf (discussing stress testing methodologies).

183. *Cf.* Packin, *supra* note 182, at 439.

184. It is unlikely that board members will be experts in risk assessment, but the board committee should have access to internal risk management officials and would retain external risk management experts to advise it and to work with the endowment's chief risk officer. The use of outside experts to assist board committees is a common practice. Audit committees retain accounting firms and consultants. Nominating committees often retain search firms to find board candidates. Compensation committees retain compensation consultants, and investment committees delegate their responsibilities to outside advisers and managers.

appropriate level of risk should not be determined merely by financial theories, general legal principles, or blind confidence in board members' expertise in finance. Rather, it should be determined through an informed consensus of the whole governing body as to which types of investments are suitable for the endowment's purposes and will give a sufficient measure of comfort that the mission of the fund will be achieved.[185]

This article does not suggest that institutions should abandon the endowment model of investing or the Modern Portfolio Theory, or that any specific level of endowment risk is appropriate or not. It merely recommends that there should be deliberation of the institution's risk tolerance by the full board. Recognition of Justice Putnam's warning in *Harvard College v. Amory*, "[d]o what you will, the capital is at hazard,"[186] and the realization of the consequences of assuming too much risk are likely to lead to more measured results, rather than a blind adherence to the endowment model of investing and increased returns.

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185. UPMIFA, *supra* note 1, at § 3(e)(1) (2006) (contains a list of steps that fund trustees should engage in when determining their risk level).

186. Harvard Coll. v. Amory, 26 Mass. 446, 468 (1830). *See* discussion *supra* Part II.

APPENDIX I: UNIVERSITY BUDGET CUTS AND AUSTERITY EFFORTS

University	Cuts and Reductions*
Boston College	Pay freeze on all staff making more than $75,000.[1]
	Unspecified number of unfilled positions eliminated.[1]
	Delayed construction of a science complex.[1]
Boston University	51 persons laid off.[1]
	200 positions eliminated.[1]
	Hiring freeze in place since 2008.[1]
	Halt of $130 million in new construction projects.[1]
	250 lay-offs at affiliated BU School of Medicine.[1]
Brandeis	Over 82 lay-offs.[1]
	Attempted closure of the Rose Art Museum and sale of its 6,000 pieces. Value approximated at $350 million.[1]
Dartmouth	Laid off or eliminated 275 staff positions.[1]
	Reduced hours for 107 employees.[1]
	Encouraged 105 early retirements.[1]
	Imposed a 2010 hiring freeze.[1]
	Delay of renovations for 5 years.[1]
	Postponement of new construction.[1]

Harvard	310 persons laid off.[1]
	530 early retirements.[1]
	103 persons had their hours reduced.[1]
	Suspension of initiative to expand into Allston,** resulting in postponement of expected jobs, stalled economic development, idle use of land. The project was expected to create 14,000-15,000 jobs over the next 50 years.[1]
	275 employees laid-off; others forced to early retirement.[2]
	Cut hot breakfasts in undergraduate dining halls.[2]
	Cut undergraduate academic advising.[2]
	Cut student employment opportunities at university libraries.[2]
	Suspended university's expansion into Allston.[2]
	Cut staff hours at university libraries.[2]
	Cut primary care division at university hospitals.[2]
	Cut shuttle service for students at distant dorms.[2]
	Cut funding for undergraduate dorms.[2]
	Increased section sizes.[2]
	Suspended annual conferences.[2]
	Cancelled program that waived 3rd year tuition for law students that met community service requirements and pledged to go into public service.[3]

MIT	135 staff laid off.[1]
	Unquantified others have had their hours reduced.[1]
	5% budget reductions in 2009; and 10-15% for the following three years.[2]
	Delayed renovations to undergraduate dorms.[2]
	Salary freeze for highest-compensated faculty.[2]
	Increase in student fees.[2]
	Closed two branches of the library.[2]
	30-50% reduction of admissions outreach travel spending.[2]
	Elimination of eight athletic teams.[2]
Princeton	Salary freezes for the best-compensated faculty and staff.[2]
	A freeze on construction.[2]
	Reduction or elimination of scholarly activities not related to teaching and research, including “certain outside conferences and colloquia.”[2]
	Reductions in undergraduate research opportunities.[2]
	Reductions in graduate funding in the humanities.[2]
	“Dramatic” reduction in campus civic engagement funding.[2]
	Reductions in outreach-related admissions travel.[2]
Stanford	Budget cuts across the university by 12-15%.[2]
	12% reduction in staff size at the Graduate School of Business including: cuts to travel, food, library services, marketing activities, printing expenses.[2]
	Hiring freezes for forty-nine ongoing staff searches.[2]
	Leaving faculty vacancies unfilled.[2]
	University layoffs of 350 administrative positions.[2]
	“Dramatic” reductions in undergraduate peer advising.[2]

Yale	Overall budget reduction of 5%; later raised to 7.5%.[2]
	Suspension of capital projects for its business school, museum, science building, and undergraduate dorms.[2]
	Reduced hours for some student and permanent employees.[2]
	20% cuts to undergraduate government.[2]
	Reduction of library digitization projects.[2]

* All employment figures are subject to revision.

** Economic Impacts of Harvard's Allston Delays: Direct Earnings Loss is approximated at ~$90,000,000 per delayed year; Total Regional Economic Loss is approximated at ~$285,000,000 per delayed year.

1. Center for Social Philanthropy Tellus Institute, *Educational Endowments and the Financial Crisis: Social Costs and Systemic Risks in the Shadow Banking System* (2011).

2. Peter Conti-Brown, *Scarcity Amidst Wealth: The Law, Finance, and Culture of Elite University Endowments in Financial Crisis*, 63 STAN. L. REV. 699 (2011).

3. Jennifer Levitz, *Economy Tests Harvard—Elite Universities See Recession's Toll on Endowments, Pinching Operating Costs*, WALL ST. J., July 31, 2012, at A3.

SOMETHING CORPORATE:

THE CASE FOR TREATING PROPRIETARY EDUCATION INSTITUTIONS LIKE CORPORATIONS

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INTRODUCTION

A. Cautionary Proprietary Education "Folktale" from the Bluegrass State

Among the most important purposes of the folktale is that it serves as a vehicle for identifying society's strengths and shortcomings. Folktales make sense of an often chaotic world. The damsel-in-distress who is tricked into the clutches of the villain serves both as a cautionary tale and emphasizes the importance of right behavior.[1] With that in mind, here is a brief tale.

Picture the archetypal female student featured in any admission pamphlet, blithely procrastinating on a class assignment by enjoying a sunny afternoon on the college green. This carefree scholar, in her idyllic collegiate setting, is not "Jane." Jane is more like Cinderella (pre-fairy-godmother); she comes from a lower socioeconomic and educational background and always aspired to be a paralegal.[2] Initially attracted by a low-cost paralegal degree program and the promise of assistance in her post-graduation job search, Jane decided to enroll at Daymar College's Louisville campus because—she claims—one of Daymar's employees promised her that that the academic credits she earned at Daymar would transfer to

1. BRUNO BETTELHEIM, THE USES OF ENCHANTMENT: THE MEANING AND IMPORTANCE OF FAIRY TALES 9 (1976).

2. Anna Prendergrast, *Thirty-nine Louisville Students Join Daymar College Lawsuit*, WHAS11 (Feb. 23, 2011, 11:34 PM), http://www.WHAS11.com/community/116784023.html. In the interest of brevity and uniformity in conveying this cautionary tale, the student's real name and demographic information have been intentionally removed by the author.

other schools.[3]

We know how this story ends; in a post-Madoff world, we are conditioned to be cautious—if not disbelieving—of promises that seem too good to be true. But Jane took Daymar's promise on faith. After receiving her paralegal degree, she found herself saddled with over thirty thousand dollars of debt and no job prospects.[4] Worse yet, Jane discovered the grim reality that her Daymar College credits were essentially worth nothing.[5] Not only was her degree from Daymar College an insufficient credential in the paralegal job market, but the promise on which she relied in choosing Daymar College—the value in the transferability of her credits—proved to be illusory. No other four-year school in Kentucky would accept the course credits from Daymar College for transfer into one of its four-year degree programs.[6]

Sadly, Jane's experience was not unique. Other Daymar students have alleged that Daymar and its representatives misled them about critical information regarding financial aid and textbooks. For example, students alleged that Daymar forced them to purchase textbooks and supplies from only Daymar's bookstore at substantially higher rates than other vendors.[7] Like Jane, a number of students have alleged that Daymar employed many unfair and deceptive practices in recruiting and enrolling students:

> [E]nrolling and retaining students with false assurances that their credits will transfer to public or traditional schools, when, in fact, the credits do not transfer in most circumstances; offering programs that do not meet the career educational standards of Daymar College's own institutional accreditation organization; recruiting and enrolling students who incur substantial debt to attend Daymar College, but do not meet Daymar College's own admission standards and so are unable to complete the program and/or obtain a job in their field.[8]

Further, students allege that Daymar representatives made oral statements to students that their Daymar credits would transfer to other colleges and universities, made inaccurate written statements about the transferability of Daymar credits, and did not inform prospective students that their Daymar credits were unlikely to transfer.[9] For these reasons, the Attorney

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3. *Id.* It is important to note that the statements made by Jane explaining why she enrolled at Daymar College are gleaned from court documents and news articles. *Id.* *See also infra* note 7.

4. Prendergrast, *supra* note 2.

5. *Id.*

6. *Id.*

7. Complaint at 4, Commonwealth v. Daymar Learning, Inc., No. 11-CI-01016 (Daviess Cir. Ct., Div. I, July 27, 2011).

8. *Id.*

9. *Id.* at 6.

General of the Commonwealth of Kentucky filed a civil complaint against the institution in the Daviess County Circuit Court in July 2011.[10]

If true, such practices undoubtedly disenfranchise students, like Jane, who were recruited under a false pretense to attend a for-profit institution. Significantly, the complaint against Daymar also alleges that Daymar misreported the cost of its degree programs and did not disclose adequate information to prospective students about costs and financial aid options for attending Daymar.[11] Furthermore, if the complaint's allegations are true, Daymar and its representatives took "the financial aid monies owing and belonging to students and us[ed] these monies for [Daymar College's] use and benefit by denying students access to their funds for any purpose other than purchasing textbooks, supplies and services from Daymar College."[12] Deceptive practices like those alleged in the complaint not only serve to further elevate the unequal informational position of the proprietary institution over the student, but also unfairly foist insurmountable student loan debt upon those students. This unconscionable scenario, if true, requires those victims be permitted a viable means of redress against such transgressions.[13]

Yet, the idea that America needs proprietary schools has become some

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10. *Id.* at 1. Later, Daymar moved to remove the case to federal district court and to have the action against it dismissed, alleging "conflict preemption" and a failure to satisfy the pleading requirements. The U.S. District Court for the Western District of Kentucky denied the motion and remanded the case, upon the plaintiff's motion, to the Daviess County Circuit Court. *See* Kentucky *ex rel.* Conway v. Daymar Learning, Inc., CA No. 4:11CV-00103-JHM, 2012 WL 1014989, at *1–7 (W.D. Ky. Mar. 22, 2012). At the time of this writing, this case has not reached resolution.

11. *Kentucky* ex rel. *Conway*, 2012 WL 1014989 at *5.

12. *Id.* at *7.

13. With the passage of a bill by the Kentucky General Assembly in 2009, that body backed innovative education reform to promote student, institution, and career readiness. *See* Act of Mar 25, 2009, ch. 101, 2009 Ky. Acts 1114 (codified at KY. REV. STAT. ANN. § 158.6453). At a time, such as now, when Kentucky ranks among the bottom forty states in its unemployment rate—just over nine percent—it is imperative that the state legislature honor its promise to protect students in the Commonwealth from being: recruited under false pretenses; depleted of much needed financial aid; and, if he or she is lucky enough to be considered for a job in an oversupplied occupation, sent out into the workforce without the competitive advantage of an education calculated to effectuate the student's career success. *See Unemployment Rates for States*, BUREAU OF LABOR STATISTICS, http://www.bls.gov/web/laus/laumstrk.htm (last modified Jan. 28, 2014); *Economy at a Glance: Kentucky*, BUREAU OF LABOR STATISTICS, http://www.bls.gov/eag/eag.ky.htm (last updated Feb. 20, 2014); RICHARD L. HEMBRA, U.S. GOV'T. ACCOUNTABILITY OFFICE, GAO-97-104, PROPRIETARY SCHOOLS: MILLIONS SPENT TO TRAIN STUDENTS FOR OVERSUPPLIED OCCUPATIONS (1997), *available at* http://www.gao.gov/assets/230/224276.pdf. Kentucky's unemployment rate is higher than the national average by more than half a point. *See* Chris Ott, *Kentucky Unemployment Rate Drops to 9.1%*, LOUISVILLE COURIER-JOURNAL (Jan. 20, 2012) *available at* http://www.courier-jounal.com/article/B2/20120119/BUSINESS/301190042 /kentucky%20unemployment%20rate.

thing of a truism, as these schools do play a key role in the world of higher education,[14] offering services to an important and unique student demographic that, like Jane, is largely female, financially independent, and over the age of twenty-five.[15] Additionally, students attending proprietary schools are more likely to be veterans, to have family incomes near or below the poverty level, and to have a parent without at least an associate's degree than a student at non-proprietary postsecondary institutions.[16] Furthermore, though they serve a disproportionately large number of economically disadvantaged students[17] and veterans,[18] the necessity for (and suc-

14. Goldie Blumenstyk, *Nonprofit Colleges Compete on For-Profits' Turf*, CHRON. HIGHER EDUC. (Jun. 1621, 2013), http://chronicle.com/article/For-Profit-Colleges-Consider/139851/. This idea has been voiced not only by members of the proprietary education sector, but also by public higher education figures such as Mitchell E. Daniels, Jr., President of Purdue University, and Freeman A. Hrabowski III, President of University of Maryland-Baltimore County. *Id.*

15. Kelly Field, *Demographics Do Not Explain For-Profit Colleges' Shortcomings on Student-Success Measures GAO Says*, CHRON. HIGHER EDUC. (Dec. 7, 2011), http://chronicle.com/article/Demographics-Do-Not-Explain/130040/.

16. *Id. See also* GEORGE A. SCOTT, U.S. GOV'T. ACCOUNTABILITY OFFICE, GAO-12-143, POSTSECONDARY EDUCATION: STUDENT OUTCOMES VARY AT FOR-PROFIT, NONPROFIT, AND PUBLIC SCHOOLS (2011), *available at* http://www.gao.gov/assets/590/586738.pdf; Paul Fain & Scott Jaschik, *Obama on For-Profits*, INSIDE HIGHER ED (Aug. 26, 2013), http://www.insidehighered.com/news/2013/08/26/obama-speaks-directly-profit-higher-education-noting-concerns-sector.

> [I]n a question-and-answer session at the State University of New York at Binghamton, a doctoral student . . . asked the president about the sector and for-profit colleges that the student called 'predatory.' The president responded with some language that didn't go over well with officials in for-profit higher education. He agreed that some for-profit colleges are taking advantage of students (and in particular veterans) . . . .

Id.

17. GEORGE A. SCOTT, U.S. GOV'T. ACCOUNTABILITY OFFICE, GAO-09-600, PROPRIETARY SCHOOLS: STRONGER DEPARTMENT OF EDUCATION OVERSIGHT NEEDED TO HELP ENSURE ONLY ELIGIBLE STUDENTS RECEIVE FEDERAL STUDENT AID (2009), *available at* http://www.gao.gov/new.items/d09600.pdf. The article states:

> Academic researchers have found that higher default rates at proprietary schools are linked to the characteristics of the students who attend these schools. Specifically, students who come from low income backgrounds and from families who lack higher education are more likely to default on their loans, and data show that students from proprietary schools are more likely to come from low income families and have parents who do not hold a college degree.

Id. See also Neil S. Seftor & Sarah E. Turner, *Back to School: Federal Student Aid Policy and Adult College Enrollment*, 37 J. HUMAN RES. 336 (2002); Richard N. Apling, *Proprietary Schools and Their Students*, 64 J. HIGHER EDUC. 379 (1993).

18. Aaron Smith, *For-Profit Schools Cash in on the GI Bill*, CNNMONEY (June 26, 2012, 10:46 AM), http://money.cnn.com/2012/06/26/news/economy/veterans-schools/index.htm.

> The Department of Veterans Affairs bankrolls four years of higher education for veterans who have served since September 11, 2001. The VA paid out

cess of) proprietary schools is undercut by the lack of proprietary school graduates trained to work in the highly skilled fields that the market most demands, like engineering and the biosciences.[19] But unscrupulous proprietary schools, and the inability of the proprietary education industry to self-regulate, seem to altogether impair the demand and respect for such schools.[20] Jane's story is a cautionary tale, which presents an opportunity to emphasize the need for, and indeed to demand, ethical behavior from these institutions in the form of fair dealing and greater transparency.

B. Proprietary Education: A Current Snapshot

As recently as the year 2000, most litigation involving proprietary education institutions concerned inflated or false representations made by proprietary school representatives; today, however, the frequency of these suits is dwindling.[21] While it may be alarming that Jane's tale takes place in the

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> $4.4 billion for tuition and fees in the two academic years spanning 2009 to 2011. For-profit private schools raked in 37% of those funds, but educated just 25% of veterans, according to the U.S. Senate's Health, Education, Labor and Pensions (HELP) committee.

Id.

19. *See* Blumenstyk, *supra* note 14.

> 'They don't have a heavy presence in STEM,' said Brian K. Fitzgerald, chief executive of the Business-Higher Education Forum . . . . Georgetown University's Anthony Carnevale, a labor economist who studies the connections between academic credentials and job markets, says the growth of online education in the nonprofit sectors and the rise of MOOCs and other alternative forms of higher education change the equation regarding the 'need' for for-profit colleges. Without them, he said, 'the loss wouldn't be monumental' to the economy, but the nation would 'lose a substantial set of earnings opportunities for people' being trained for jobs in medical technology, culinary arts, and high-tech mechanical fields. 'They're good at HVAC,' said Mr. Carnevale . . . . 'The question is whether the earnings are worth the price.'

Id.

20. Frank Donoghue, *Who Goes to For-Profit Colleges?*, CHRON. HIGHER EDUC. (June 27, 2011), http://chronicle.com/blogs/innovations/who-goes-to-for-profit-colleges/29725.

> For-profit colleges and universities educate [twelve percent] of the postsecondary population, but have huge attrition rates and [account for] half of the federal loan defaults, measured in dollars. That ratio suggests that the for-profits are only interested in enrolling students—any students—but don't particularly care if those students graduate, get well-paying jobs and are thus able to pay back their student loans.

Id.

21. *See* Patrick F. Linehan, Note, *Dreams Protected: A New Approach to Policing Proprietary Schools' Misrepresentations*, 89 GEO. L.J. 753, 754 (2001) (citing U.S. GOV'T. ACCOUNTABILITY OFFICE, T-HEHS-96-158, HIGHER EDUC.: ENSURING QUALITY EDUC. FROM PROPRIETARY EDUC. INSTS. (1996), *available at* http://www.gao.gov/assets/110/106522.pdf (statement of Cornelia M. Blanchette before the Subcommittee on Human Resources and Intergovernmental Relations).

modern era, it is perhaps not so surprising that change takes a touch longer than usual to reach Kentucky.[22] At first blush, it reflects positively on the proprietary education industry that fraudulent misrepresentation suits are down, perhaps a sign that the schools are reining in their extravagant promises to students, or that students are becoming savvy to the traditional deceptive recruitment practices. Unfortunately, reality is less rosy. If anything, Jane's cautionary tale, and other true stories like it, has led to an unintended consequence. Learning to couch misrepresentations as legally permissible puffery, some proprietary education institutions have merely evolved and now employ more erudite methods of trickery. State governments, however, have yet to take notice of the fact that a growing number of proprietary schools have developed new practices of profit generation, often at the expense of students.

With substantial sums of money at stake, federal financial aid has become the new fiscal focus of many proprietary schools. In 2012, Senator Tom Harkin issued the final report of his two-year investigation of the proprietary education industry.[23] The report reveals that taxpayers spent $32 billion in 2011 on postsecondary proprietary education institutions in the form of federal financial aid; but most students at for-profit colleges left without earning degrees or certificates.[24] Worse, half of those students left those schools within four months of enrolling for classes.[25] Yet, despite this unsettling statistic, an even more distressing facet of the federal financial aid system—the zero-sum game—has been brought to the fore by the practices of a few unprincipled proprietary schools.[26] If a student withdraws from a proprietary school in the middle of the semester: (1) the student forfeits his or her financial aid award for the semester and may be responsible for imminent repayment of the award; (2) a non-proprietary school, already wearing a tighter belt amidst deep cuts to its operating budget, loses out on the financial aid award that the student brought to the proprietary school; and (3) the proprietary school keeps most, if not all, of the federal financial aid award without having educate the very student who brought his or her federal financial aid money to the school in the first place.[27]

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22. The great 19th century humorist Mark Twain is credited as the originator of this quip about the Bluegrass State: "I want to be in Kentucky when the end of the world comes, because it's always 20 years behind." Rebecca Kaplan, *Immersed in the Bluegrass State*, LANGUAGE MAG., http://languagemagazine.com/?page_id=4415 (last visited Feb. 24, 2014).

23. Tamar Lewin, *Senate Committee Report on For-Profit Colleges Condemns Costs and Practices*, N.Y. TIMES, July 29, 2012, at A12.

24. *Id.*

25. *Id.*

26. *Id.*

27. Paul Fain, *Results Are In*, INSIDE HIGHER ED (July 30, 2012), http://www.insidehighered.com/news/2012/07/30/harkin-releases-critical-report-profits (noting a troubling sixty-four percent dropout rate in associate degree programs).

The Harkin Report's startling findings demand attention. That "education is perhaps the most important function of state and local governments"[28] is as true today as it was in 1954 when the Supreme Court proclaimed it. This article's goal is to argue that postsecondary education, particularly proprietary postsecondary education, has become a product-driven industry in the modern era, and as such, the law should apply the same accountability standards to proprietary schools that it applies to other proprietary entities. Because states are best positioned to regulate the institutions within their own borders, they should seize the opportunity to regulate the proprietary education industry by requiring more robust disclosure about its operations. As the cases regarding the deceptive trade practices of proprietary education institutions continue to funnel through the American court system, the argument for legislation requiring proprietary education institutions to disclose vital investment information to potential consumers should be given due concern.

In Part I, this article examines (1) the history of proprietary colleges and universities, distinguishing them from traditional postsecondary colleges and universities; (2) the modern reality of the educational marketplace; and (3) the organizational structure of proprietary schools. Given this context, the article posits that the regulation of the proprietary education industry is more akin to regulating a traditional corporation than regulating a traditional postsecondary school. Next, Part II introduces the academic abstention doctrine that has long been a fixture in the courts and scrutinizes the historical causes of action against proprietary schools, arguing that they are inadequate in the modern era. Part III considers the role that deceptive trade practices, such as inadequate disclosure, have in relation to the current student loan default rate crisis and contends that the states are better positioned to regulate proprietary schools' harmful trade practices than the federal government. In Part IV, this article turns to the modern evolution of fiduciary duties and the corporate elements of proprietary schools, asserting that general fiduciary duties, existing between proprietary education institutions and their students, should supplant the academic abstention doctrine. Finally, Part V makes a realistic recommendation for the regulation of proprietary educational institutions as for-profit enterprises, distinguishing proprietary schools from other educational institutions with which the law has mistakenly associated them.

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28. Brown v. Bd. of Educ., 347 U.S. 483, 493 (1954). By acknowledging the priority of education as a function of state and local government, the Supreme Court implicitly deferred to the states and municipalities with regard to education. More recently, consumer protection laws have become an avenue by which states shoulder the burden of protecting the uneducated. *Id.*

I. THE HISTORICAL RISE OF PROPRIETARY EDUCATION INSTITUTIONS

Although the proprietary education model is often regarded as a modern invention, the history of proprietary schools in this country is quite established, predating even the signing of the Declaration of Independence.[29] As alternatives to apprenticeships and the colleges of the day, proprietary schools served important purposes during the Colonial period and early years of the nation.[30] Eventually, these schools began to teach career training in addition to basic literacy; since the late nineteenth century, proprietary education institutions have existed to keep up with the market's demand for vocationally educated and trained members of the workforce.[31] Historically, these institutions existed for the purpose of offering a career path for students who either did not fit into, or were neglected by, the traditional postsecondary education model.[32] In the second half of the twentieth century, however, the proprietary education industry took up a different mantle with a more profit-centered focus. The industry saw exponential growth after the Higher Education Amendments[33] were enacted in 1972, which granted proprietary schools eligibility to participate in Title IV programs and thereby provided these schools federally-backed student financial aid packages.[34]

In the late 1990's, some five thousand proprietary education institutions served over one million students, with over two-thirds of those students receiving Title IV federal student aid; at the same time, proprietary education institutions comprised fifty percent of all postsecondary institutions and served slightly greater than half of all non-baccalaureate students attending postsecondary schools.[35] Even since then, proprietary education has seen

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29. Aaron N. Taylor, *"Your Results May Vary": Protecting Students and Taxpayers Through Tighter Regulation of Proprietary School Representations*, 62 ADMIN. L. REV. 729, 752–53 (citing LISA K. FOSTER, CAL. STATE LIBRARY, CRB 04-010, FOR-PROFIT POSTSECONDARY EDUCATIONAL INSTITUTIONS: OVERVIEW OF ACCREDITATION AND STATE AND FEDERAL OVERSIGHT 13 (2004)).

30. *Id.*

31. *See* Melvin L. Barlow, *200 Years of Vocational Education*, 51 AM. VOCATIONAL J. 1 (1976) (detailing the origins, early history, and the evolution of proprietary and vocational schools in the United States). *See also* RICHARD S. RUCH, HIGHER ED, INC.: THE RISE OF THE FOR-PROFIT UNIVERSITY 52 (2001) (chronicling how student interest prompted early proprietary schools to expand their curricula to include courses that taught "skills that were in high demand by employers").

32. Michael J. Seiden, *For-Profit Colleges Deserve Some Respect*, CHRON. HIGHER EDUC. (June 29, 2009), http://chronicle.com/article/article-content/46985/.

33. Pub. L. No. 92-318, 86 Stat. 235 (1972) (codified as amended at 20 U.S.C. § 1001 (2012)).

34. *See* Linehan, *supra* note 21, at 755–56 (discussing the proprietary education industry's regulatory framework and participation in Title IV programs as well as the importance of the Higher Education Amendments).

35. *See* SCOTT, *supra* note 16, at 5. *See also* NAT'L ASS'N FOR EDUC. STATISTICS, U.S. DEP'T OF EDUC., FINDINGS FROM VOCATIONAL EDUCATION IN THE UNITED STATES:

marked growth. The percentage of federal financial aid payouts to postsecondary schools doubled in the years between 2000 and 2010.[36] In 2010, over ninety-five percent of students enrolled in proprietary schools received some type of federal student aid.[37] In the same year, proprietary schools educated only ten percent of all postsecondary students, but proprietary schools received over twenty-three percent of all Title IV federal loans and grants.[38] To emphasize, proprietary schools now eat nearly a quarter of the overall Title IV federal loan and grant pie. This figure is illustrative of the floodgates that opened with a trickle just over forty years ago in 1972.

In certain respects, proprietary education institutions have not changed since their early history, as they continue to target minorities traditionally underrepresented at postsecondary institutions,[39] but with significant sums of federal financial funds at stake, the tactics for, and the urgency of, recruiting these students has changed.[40] This adaptation is either the underlying cause or the direct result of a sea change in postsecondary education: the paradigm shift from higher education as an intangible benefit—a way of thinking—to a commodity.

THE EARLY 1990S, at 18 tbl.1 (1996), *available at* http://nces.ed.gov/pubs97/97391.pdf.).

36. S. HEALTH, EDUC., LABOR & PENSIONS COMM., 111TH CONG., EMERGING RISK?: AN OVERVIEW OF GROWTH, SPENDING, STUDENT DEBT AND UNANSWERED QUESTIONS IN FOR-PROFIT HIGHER EDUCATION 3 (2010) [hereinafter "Harkin"], *available at* http://harkin.senate.gov/documents/pdf/4c23515814dca.pdf (2010) (statement of Tom Harkin, Chairman of the Health, Education, Labor and Pensions Committee, United States Senate).

37. SANDRA STAKLIS, NAT'L CTR. FOR EDUC. STATISTICS, U.S. DEP'T OF EDUC., WEB TABLES—PROFILE OF UNDERGRADUATE STUDENTS: 2007–08, at 109 (2010), *available at* http://nces.ed.gov/pubs2010/2010205.pdf.

38. Cheryl L. Auster, *Promising a Better Future But Delivering Debt: Understanding the Financial and Social Impact of For-Profit Colleges and the Effect of the New Program Integrity Rules*, 13 SCHOLAR 631, 634–35 (2011) (citing Harkin, *supra* note 36, at 4).

39. Welford W. Wilms, *Proprietary Schools: Strangers in Their Own Strange Land*, 19 CHANGE 10 (1987) (identifying that part of proprietary schools' appeal is that schools provide hope for students who have experienced educational failure in a more conventional setting). *See also* Cathy Lesser Mansfield, *The Federal Trade Commission Holder Rule and Its Applicability to Student Loans—Reallocating the Risk of Proprietary School Failure*, 26 WAKE FOREST L. REV. 635, 636–47 (1991) (noting that proprietary education institutions "aggressively recruit economically deprived or homeless individuals, often from welfare lines and laundromats"); *Frontline: College Inc*. (WGBH Educational Foundation television broadcast May 4, 2010), *available at* http://www.pbs.org/wgbh/pages/frontline/collegeinc/etc/script.html (transcript and video).

40. Proprietary education institutions often place their schools in locations convenient to students' homes or workplaces and accessible by regular public transportation routes, while developing advertising campaigns and messages to appeal directly to these students' desires. *See Frontline: College Inc*., *supra* note 39.

A. Commoditizing Higher Education

Postsecondary education in the United States is the unique product of a *laissez-faire* system. This backdrop precipitated an immense entrepreneurial expansion of higher education, and in turn, it yielded a wide array of postsecondary institution models.[41] Unlike the European college and university models, the American postsecondary system developed and continues to thrive with comparatively little direct influence or interference from the federal government,[42] placing it among the most market-oriented systems of higher education in the world.[43] This status is the result of historical insulation from market pressures that are pervasive in and germane to the private sector, because higher education has long held public favor.[44]

Yet, for the last century, the postsecondary education landscape bears increasing similarity to a marketplace, where students[45] and institutions play roles ranging from consumer to entrepreneur to corporation. Aaron Taylor has argued that:

> Like capitalism in general, academic capitalism is about competition—competition for funding, students, and—for some schools—prestige. The primary competitors are institutions, which are embodied by the actors who operate therein: faculty, students, and administrators. Networks are central to viability within the academic capitalist system. As such, institutional actors seek to link institutions (and themselves) to the modern,

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41. CHRISTOPHER J. LUCAS, AMERICAN HIGHER EDUCATION: A HISTORY 116–19 (2006) (noting the proliferation of American colleges and universities in the nineteenth century).

42. *See* Martin Trow, *Federalism in American Higher Education*, *in* HIGHER LEARNING IN AMERICA: 1980–2000, at 39 (Arthur Levine ed., 1993) (discussing the minimal direct influence of the federal government on the United States' postsecondary education system). *But see* Lawrence E. Gladieux & Jacqueline E. King, *The Federal Government and Higher Education*, *in* AMERICAN HIGHER EDUCATION IN THE TWENTY-FIRST CENTURY: SOCIAL, POLITICAL, AND ECONOMIC CHALLENGES 151 (Philip G. Altbach et al. eds., 2d ed. 2005) (arguing that the historical influence of the federal government on the United States' postsecondary education system has been pervasive).

43. *See* Taylor, *supra* note 29, at 742 (citing David D. Dill, *Allowing the Market to Rule: The Case of the United States*, 57 HIGHER EDUC. Q. 136, 137 (2003) (discussing the increased "marketization" of higher education and its impact on the public interest)). *See also* DAVID L. KIRP, SHAKESPEARE, EINSTEIN, AND THE BOTTOM LINE: THE MARKETING OF HIGHER EDUCATION 2 (2003) ("For better or worse—for better *and* worse, really—American higher education is being transformed by both the power and the ethic of the marketplace.").

44. *See* Taylor, *supra* note 29, at 743.

45. *See* SHEILA SLAUGHTER & GARY RHOADES, ACADEMIC CAPITALISM AND THE NEW ECONOMY: MARKETS, STATE, AND HIGHER EDUCATION 12 (2004) ("[R]aising tuition . . . has heightened students' and parents' consumer consciousness about what they expect in terms of their educational experience. . . . These changed expectations reshape student identity from that of learner to that of consumer.").

> knowledge-based economy. These links most often take the form of 'new circuits of knowledge'—partnerships with the private sector, investments in marketing, product development and student services, and an expanded managerial core to handle these new demands. Fundamentally, the goal of institutions competing in this environment is to generate income, particularly from 'alternative revenue streams,' with the assumption that robust, diversified funding will lead to greater prestige, better students, and increased viability.[46]

Regardless of the dangers associated with higher education mimicking the marketplace, the shift to a knowledge-based economy is undeniable. This economy is based on the theory that "knowledge is a commodity that when exploited can reap tangible benefits [for] the possessor."[47] Because postsecondary education institutions are considered "a major source of alienable knowledge," these institutions are at the very center of a knowledge-based economy.[48] Learning for the sake of learning, however, is the first thing to fall by the wayside in a knowledge-based economy, quickly ceding to the contemporary reality that education is increasingly regarded as a private pursuit, not a public good.[49] This paradigm shift does not sit well with members of the professoriate who increasingly complain about the consumer mentality of their students.[50] However, postsecondary education institutions have long benefitted from the fact that they know more about prospective students than these students know about the institu-

46. *See* Taylor, *supra* note 29, at 743–44 (citations omitted).

47. *Id.* at 744 (citing SLAUGHTER & RHOADES, *supra* note 45, at 15 ("[K]nowledge is a raw material to be converted to products, processes, or service.")). *See also* Andre v. Pace Univ., 618 N.Y.S.2d 975, 979 (N.Y. City Ct. 1994), *rev'd*, 655 N.Y.S.2d 777 (N.Y. App. Term 1996) ("Colleges and Universities are in the business of marketing and delivering educational services and degrees to the general public.").

48. *See* Taylor, *supra* note 29, at 744 (citing SLAUGHTER & RHOADES, *supra* note 45, at 15) (internal quotation marks omitted).

49. SLAUGHTER & RHOADES, *supra* note 45, at 42–43 (citation omitted) ("By the 1980s and 1990s, higher education was construed less as a necessary public or social good and more as an individual or private good, justifying 'user pays' policies."). *See also* Vikki Conwell, *For-Profit Schools Under Pressure to Prove Investment in Education Pays Off*, DIVERSE ISSUES IN HIGHER EDUC. (Aug. 25, 2013), http://diverseeducation.com/article/55498/#.

> As college tuition costs rise, more students, parents and taxpayers are asking institutions to show a return on the financial investment. . . . 'Institutions need to be nervous because more and more people want to know about the economic value of the education,' said Anthony P. Carnevale, director and Research Professor of the Georgetown University Center on Education and the Workforce.

Id.

50. Jeffery Selingo, *Colleges Must Prepare for a Buyers Market*, CHRON. HIGHER EDUC. (Apr. 12, 2013), https://chronicle.com/article/Colleges-Must-Prepare-for-a/138383/.

tions.[51] Even though the classroom may be an improper forum for a student's consumer mentality, the modern academic marketplace requires that a student be a savvy consumer of postsecondary education in choosing the institution that the student "calculate[s] [is] likely to bring a return on educational investment."[52]

B. The Structural Advantage of Proprietary Education Institutions

No two proprietary schools are organized exactly alike. That said, many proprietary schools have a structural framework in which a chief administrator, usually the director of the corporation which owns the school, is aided by a small administrative staff.[53] The "responsibility for admissions, financial aid, recruitment and instructional program [is] usually delegated to others."[54] In essence, these institutions exhibit classic corporate organization, where the plenary power of running a corporation resides with the director who oversees the officers' work as agents of the corporation.[55] Despite the even greater variety of governance models at traditional postsecondary schools, the proprietary institution model, with its power centralized in one person or only a few people, stands in stark contrast to the institutional or system-wide governing board typical of most traditional postsecondary schools. These models are, quite simply, diametrically opposed.

Traditional, non-proprietary, postsecondary schools rely on alumni and private donations, grants, tuition payments, and (in the case of state schools) state appropriations to do the heavy lifting for the school's operational budget. In contrast, proprietary schools rely almost entirely on enrollment as a means of boosting profit. Because Title IV financial aid is moveable, students can choose to take their federal financial aid grants and loans to any educational institution contemplated by the Higher Education Amendments—including proprietary schools. Enrollment is a crucial com

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51. *See id. See also* James M. Lang, *Is College Worth It?*, NOTRE DAME MAG. 22–27 (2013), http://magazine.nd.edu/archives/2013/summer-2013/.

52. *See* Taylor, *supra* note 29, at 745 (citing SLAUGHTER & RHOADES, *supra* note 45, at 1–2) (discussing how students "increasingly choose majors linked to the new economy, such as business, communications, [and] media arts"). *See also* Lang, *supra* note 51.

53. Of the four in-state, for-profit colleges licensed to operate in the Commonwealth of Kentucky by the Council on Postsecondary Education, two entities carry assumed names, and are entities related to only two institutions, comprised of two officers, and three director-officers, respectively. *See* KY. SECRETARY OF ST. ONLINE SERVICES, http://app.sos.ky.gov/ftsearch/ (search "Daymar Learning, Inc." and "The Sullivan University System, Inc.") (last visited Feb. 24, 2014).

54. Linehan, *supra* note 21, at 756. *See also* Wilms, *supra* note 39, at 14–15.

55. *See generally* ROBERT W. HAMILTON ET AL., CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 11 (11th ed. 2010).

ponent of the financial health at a proprietary school because of the federal funding that is guaranteed to the school by a Title IV qualifying student's enrollment. In fact, some of the largest proprietary education institutions in the country, such as the University of Phoenix and Kaplan University, derive ninety percent of their revenue from federal financial aid funding.[56] As a result, historically, several proprietary schools conditioned recruiters' and admission counselors' salaries on the actual tuition paid by students personally persuaded to enroll by the recruiter or counselor.[57] Not only can such practices provide an incentive for recruiters and admission counselors to mislead prospective students (because the federal financial aid funding stays with the proprietary school even if the student bringing the funding to the school drops out), but the proprietary school also has a disincentive to expend resources on enrolled students.[58]

In theory, the current trend of rising tuition costs at non-proprietary post-secondary institutions[59] should carve out a growing enrollment base for the

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56. Daniel Luzer, *The Financial Future of For-Profit Colleges*, WASH. MONTHLY (June 25, 2012, 6:46 PM), http://www.washingtonmonthly.com/college_guide/blog/the_financial_future_of_forpro.php. *See also* Daniel Luzer, *Cracking Down on Military Money and For-Profit Colleges*, WASH. MONTHLY (Feb. 21, 2012), http://www.washingtonmonthly.com/college_guide/blog/cracking_down_on_military_mone.php.

> Under current rules, for-profit colleges are not allowed to derive more than [ninety] percent of their revenues from federal financial aid. But veterans' benefits and payments from the military's tuition assistance program don't count as federal financial aid. Because of this, many critics argue that for-profit schools are deliberately enrolling unprepared soldiers and veterans into their programs. Enrolling soldiers and veterans not only allows for-profits to avoid sanctions for making too much money off traditional financial aid, it also enables them to enroll more traditional students. . . . Since 2008, for-profit colleges have seen a [six hundred] percent increase in income derived from military education programs.

Id.

57. Linehan *supra* note 21, at 756 (citing S. Rep. No. 102-58, at 7 (1991) (discussing instances wherein schools' sales representative earned incentive awards for enrolling the highest number of students for a given period, wherein receptionists with the highest number of student phone contacts were given time off, and wherein loan counselors received cash, color televisions, and other awards for the highest number of applications processed). *See also* Moy v. Terranova, No. 87-CV1578-SJ, 1999 WL 118773, at *1 (E.D.N.Y. Mar. 2, 1999) (noting an allegation that defendant proprietary school sent a salesmen into poor neighborhoods to recruit students on a commission basis). For a chronicling of proprietary schools that continued this practice as recently as 2009, see Barry Yeoman, *The High Price of For-Profit Colleges*, AM. ASS'N. OF UNIV. PROFESSORS (2011), http://www.aaup.org/article/high-price-profit-colleges#.Uj-ZpxY2lK4. *See also* Sharona Coutts, *Recruiter's Experience at One For-Profit University Suggests Reform Efforts Will Face Hurdles*, PROPUBLICA (Feb. 14, 2011, 1:30 PM), http://www.propublica.org/article/recruiters-experience-at-one-for-profit-university-suggests-reform-efforts-.

58. *See* Linehan, *supra* note 21, at 756–60.

59. Allie Bidwell, *The Rise in Tuition is Slowing, But College Still Costs More*,

proprietary institutions, which can raise tuition without fear of displacement in the market, so long as their tuition rate remains below that of traditional postsecondary schools. In practice, however, most proprietary schools charge much higher tuition than comparable programs at community colleges and flagship public universities.[60] In fact, Senator Harkin's 2012 congressional investigation found that proprietary associate degree and certificate programs averaged nearly four times the cost of comparable degree programs at community colleges.[61] Similarly, bachelor's degree programs offered by proprietary schools cost twenty percent more on average than the cost of analogous programs at flagship public universities, even though the credits earned at proprietary schools are almost always non-transferrable.[62] A study issued by the National Bureau of Economic Research in 2012 demonstrated that:

> Many for-profit institutions that are not Title IV eligible offer certificate (non-degree) programs that are similar, if not identical, to those given by institutions that are Title IV eligible. We find that the Title IV institutions charge tuition that is about [seventy-

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USNEWS (Oct. 24, 2013), http://www.usnews.com/news/articles/2013/10/24/the-rise-in-tuition-is-slowing-but-college-still-costs-more.

60. *See* Harkin, *supra* note 36, at 8–9. "In many cases . . . [comparable] public and nonprofit options are far less expensive than the for-profits are." Blumenstyk, *supra* note 14. The reason for the rising cost of tuition, which has recently out-paced inflation in most areas, is a multifaceted inquiry. *See* Derek Thompson, *Why Are Colleges Getting So Expensive?*, ATLANTIC (Dec. 4, 2013, 10:44 AM), http://www.theatlantic.com/video/archive/2013/12/why-are-colleges-getting-so-expensive/282027/ (stating, simply, that "[d]ifferent schools are getting [more] expensive for different reasons"); Peter High, *Education Technology Is in Its Infancy But It Is Growing up Fast*, FORBES (Dec. 9, 2013, 8:03 AM), http://www.forbes.com/sites/peterhigh/2013/12/09/education-technology-is-in-its-infancy-but-it-is-growing-fast/ (purporting that the "fundamentals" of the education industry "have not dramatically changed in hundreds of years, and yet its costs have risen at a rate three times as fast as the consumer-price index"). In Kentucky, for instance, public postsecondary education tuition and fees have risen 177% in 12 years, but according to Republican state senator Chris McDaniel, the increase in cost was not accompanied by a corresponding increase in the quality of education. Nick Storm, *Ky. College Tuition and Fees Rise 177% in 12 Years, But Senator Says Academic Results Haven't Kept Up*, CN2 (Dec. 11, 2013, 6:46 PM), http://mycn2.com/politics/higher-education-tuiton-and-fees-increase-177-percent-over-12-years-but-academic-results-haven-t-improved-with-rates. On the national level, members on the other side of the aisle are, at the time of the publication of this article, introducing legislation to slow the untenable inflation of college tuition costs; this is, perhaps, because they are not-so-far-removed from postsecondary study that senators Chris Murphy (D-CT) and Brian Schatz (D-HI)—the United States Senate's two youngest members—are still paying off their student loans. Dave Collins, *Two Youngest US Senators Seek to Lower College Costs*, BOSTON GLOBE (Dec. 8, 2013), http://www.boston.com/news/education/2013/12/08/youngest-senators-seek-lower-college-costs/rdSyvIMWPwfPVJAsOzydIK/story.html (referencing the tripling of college tuition costs over the last thirty years).

61. Lewin, *supra* note 23.

62. *Id.*

> eight] percent higher than that charged by comparable institutions whose students cannot apply for federal financial aid. The dollar value of the premium is about equal to the amount of grant aid and loan subsidy received by students in eligible institutions.[63]

According to one of the authors of the study by the National Bureau of Economic Research, "the difference in price between financial-aid eligible institutions and others 'seems to match, pretty well, the size of a Pell Grant.'"[64] However, in spite of the inordinate cost and objectionable student outcomes at many proprietary schools, the enrollment at proprietary schools continues to grow, especially with its key demographic—the economically disadvantaged.[65] When these students and their futures can be reduced to figures for profit margins, they inevitably lose. In the competitive, commoditized, high-stakes marketplace of higher education, proprietary schools have the upper hand because they are organized like corporations with a clear informational advantage over student consumers.

The very characteristic that makes a proprietary school proprietary—a corporate structure that exists to maximize profits for its shareholders—

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63. Stephanie Riegg Cellini & Claudia Goldin, *Does Federal Student Aid Raise Tuition? New Evidence on For-Profit Colleges*, NAT'L BUREAU ECON. RESEARCH, http://nber.org/papers/w17827 (last revised Apr. 10, 2013). Put most simply, Title IV eligible schools are those that may receive federal student financial aid—such as Pell Grants and Stafford Loans—under Title IV of the Higher Education Act of 1965. These schools are accredited to award degrees and certificates in two and four-year programs of study. Schools awarding credentials that require less than two years of postsecondary study are not eligible for Title IV funds. *See* David J. Deming, Claudia Goldin & Lawrence F. Katz, The For-Profit Postsecondary School Sector: Nimble Critters or Agile Predators? (2011) (unpublished manuscript), *available at* http://www.frbatlanta.org/documents/news/conferences/11employment_education_demming.pdf (presented at the Federal Reserve Bank of Atlanta's second annual conference September 29, 2011). In practice, the eligibility of a proprietary school to receive Title IV funds is more complex—and currently tied to the 90/10 Rule, which mandates that a proprietary school's revenue from federal financial aid not exceed ninety percent. Goldie Blumenstyk, *For-Profit Colleges Show Increasing Dependence on Federal Student Aid*, CHRON. HIGHER EDUC. (Feb. 15, 2011), http://chronicle.com/article/For-Profit-Colleges-Show/126394/.

> The 90/10 rule applies only to for-profit colleges. And only federal student-aid money, commonly referred to as Title IV funds . . . is counted toward the [ninety] percent limit. Other sources of federal aid, such as money from the GI Bill or military tuition reimbursements that many students use to pay for college, are not treated as part of the Title IV side of the calculation.

Id.

64. Daniel Luzer, *Why Are Many For-Profit Schools So Costly?*, WASH. MONTHLY (Feb. 15, 2012, 4:01 PM), http://www.washingtonmonthly.com/college_guide/blog/why_are_many_forprofit_schools.php.

65. *See* Donoghue, *supra* note 20. "From '2000 to 2008, the percentage of low-income students enrolling in for-profits increased from [thirteen] percent to [nineteen] percent, while the percentage enrolling in public four-year institutions declined from [twenty] percent to [fifteen] percent.'" *Id.* (citations omitted).

necessarily distinguishes it from other postsecondary education institutions and is the fundamental difference between the purposes of the corporate and nonprofit models. For example, the annual convention of the Association of Private Sector Colleges, a voluntary membership organization for proprietary schools, is typically "swarming with private-equity investors, business brokers, and bankers, looking for growing colleges to buy or sell."[66] This example starkly contrasts with the environment of non-proprietary education, illustrating the disparity in function and governance between proprietary and non-proprietary schools, and underscoring the fact that—particularly with regard to predatory proprietary schools—the wolf in sheep's clothing should not be treated the same as the sheep.

Without a doubt, corporate entities have a genuine business interest in fair dealing while delivering good products to customers. However, principally, the purpose of any corporation is to maximize profits for its shareholders.[67] Given this fiduciary duty to its shareholders, a proprietary college or university is practically compelled to extract as much money as it can from its students. With the collection of student tuition fees, a proprietary school has made its money whether its students continue to show up for class or not.[68] Because the organizational structure of proprietary education institutions incentivizes withholding vital information from the consumer in the academic marketplace, as a matter of fact, proprietary schools maintain a competitive advantage over the consumer and even over their non-proprietary peers. It is time to call a spade a spade. The appropriate regulation of the proprietary education industry should not resemble the *laissez-faire* relationship between the government and non-proprietary colleges or universities; instead, proprietary colleges and universities should be regulated like the for-profit, corporate entities that they are.

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66. Blumenstyk, *supra* note 14.

67. Felix Salmon, *For-Profits vs. Not-for-Profits*, REUTERS (Jan. 16, 2012), http://blogs.reuters.com/felix-salmon/2012/01/16/for-profits-vs-not-for-profits/.

68. *Id.*

> [T]here are two main ways in which [proprietary schools] could . . . compete on price with traditional colleges. The first is to take advantage of their high drop-out rates, and use the drop-outs' tuition fees to effectively cross-subsidize the minority of students who actually finish the course. After all, if half your students have stopped showing up for class, they're not going to cost you much money. The average student will still suffer, of course, but at least those who finish the course might benefit. The other way that for-profit colleges can end up cheaper than their traditional competitors is by concentrating on costs: rather than paying enormous sums for prestigious professors and research institutes, they concentrate with a laser focus on their core business of teaching undergrads. After all, their concentration on profits means that they're likely to be more efficient than flabby old traditional not-for-profits.

Id.

II. A PRIMER TO THE ACADEMIC ABSTENTION DOCTRINE

To date, most claims against educational institutions have arisen from tort actions, specifically: (1) fraudulent representation, (2) negligent representation, and (3) educational malpractice.[69] Generally, courts will bar attempts to repackage tort claims, such as educational malpractice claims, as contract claims. This is because courts are understandably nervous about the idea of classifying the student-institution relationship as a contractual one.[70] This idea, which has come to be known as the academic abstention doctrine,[71] is also borne from policy concerns associated with utilizing a court to determine the quality of a student's education and the sufficiency of a school's ability to provide the student with an education meeting this standard for quality.[72] Thus, invoking academic abstention, many courts have declined to evaluate either the quality of an education or the sufficiency of its delivery altogether[73]—even in cases sounding in tort.[74] However,

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69. *See* Linehan, *supra* note 21, at 764 (citing Carol Crocca, Annotation, *Liability of Private Vocational or Trade School for Fraud or Misrepresentations Including Student to Enroll or Pay Fees*, 85 A.L.R. 4th 1079 (1991)) (discussing the liability of proprietary vocational schools for fraudulent inducement of student enrollment). *See also* Kevin P. McJessy, Comment, *Contract Law: The Proper Framework for Litigating Educational Liability Claims*, 89 NW. U. L. REV. 1768, 1774–83 (1995) (describing possible theories applicable to educational liability claims).

70. *See* Ross v. Creighton Univ., 957 F.2d 410 (7th Cir. 1992).

71. *See* Taylor, *supra* note 29, at 763 (defining the doctrine as the tenet that the "professional judgment of educators should be protected from the unqualified assessment of judges or other fact finders").

72. *See* Wickstrom v. N. Idaho Coll., 725 P.2d 155, 157–58 n. 1 (Idaho 1986); Hunter v. Bd. of Educ., 439 A.2d 582, 586 n.5 (Md. 1982); Torres v. Little Flower Children's Servs., 474 N.E.2d 223, 227 (N.Y. 1984).

73. Paladino v. Adelphi Univ., 454 N.Y.S.2d 868, 872 (1982).

> Where the essence of the complaint is that the school breached its agreement by failing to provide an effective education, the court is again asked to evaluate the course of instruction . . . [and] is similarly called upon to review the soundness of the method of teaching that has been adopted by an educational institution.

Id.

74. For example, courts in at least eleven states have considered and rejected claims for educational malpractice: Alabama, Alaska, California, Florida, Idaho, Iowa, Kentucky, Maryland, New Jersey, New York, and Wisconsin. *See, e.g.*, Jackson v. Drake Univ., 778 F. Supp. 1490 (S.D. Iowa 1991); Blane v. Alabama Commercial Coll., Inc., 585 So. 2d 866 (Ala. 1991); D.S.W. v. Fairbanks N. Star Borough Sch. Dist., 628 P.2d 554 (Alaska 1981); Smith v. Alameda Cnty. Soc. Servs. Agency, 153 Cal. Rptr. 712 (Cal. Ct. App. 1979); Peter W. v. S. F. Unified Sch. Dist., 131 Cal. Rptr. 3d 834 (Cal. Ct. App. 1976); Tubell v. Dade Cnty. Pub. Sch., 419 So. 2d 388 (Fla. Dist. Ct. App. 1982); *Wickstrom*, 725 P.2d 155; Moore v. Vanderloo, 386 N.W.2d 108 (Iowa 1986); Rich v. Ky Cnty. Day, Inc., 793 S.W.2d 832 (Ky. Ct. App. 1990); *Hunter*, 439 A.2d 582; Swidryk v. Saint Michael's Med. Ctr., 493 A.2d 641 (N.J. Super. Ct. Law Div. 1985); Donohue v. Copiague Union Free Sch. Dist., 391 N.E.2d 1352 (N.Y. 1979); Hoffman v. Bd. of Educ., 400 N.E.2d 317 (N.Y. 1979); Helm v. Prof'l Children's Sch., 431 N.Y.S.2d 246 (N.Y. App. Term 1980); Wilson v. Cont'l Ins. Co., 274

the widespread acceptance of the academic abstention doctrine, while defensible, is not without consequences.

A. The Inadequacy of Historical Causes of Action by Students Against Proprietary Education Institutions

Of all the claims brought against proprietary colleges and universities, educational malpractice has proven to be a virtually fruitless cause of action. Historically, fraudulent misrepresentation is the tried and true cause of action against proprietary institutions. Still, few courts have dealt with fraudulent misrepresentation cases against proprietary colleges and universities on the merits, let alone cases involving proprietary institutions. In *Paladino v. Adelphi University*, however, a New York state appellate court considered a fraudulent misrepresentation claim against a school.[75] In *Paladino*, the defendant was an elementary and secondary school, named the Waldorf School, and not a postsecondary school, as the named defendant—Adelphi University—suggests.[76] Although the plaintiff contended that the Waldorf School misrepresented the quality of the instruction that it offered, the court was highly deferential to the institution and wary to tread on educators' discretion.[77] Significantly, the court explained that when a student's expected educational results are not achieved, it is the charge of the educational community, not the judiciary, to create a solution.[78]

This decision, defensible under the doctrine of judicial restraint, is illustrative of the academic abstention doctrine and reveals the underlying problem with relying on the judiciary to resolve issues created by the deceptive trade practices of unscrupulous proprietary institutions. The *Paladino* decision is not anomalous; it is the rule rather than the exception. The judiciary does not believe itself to be the proper forum to resolve disputes where the legislature has not explicitly charged the judiciary with deciding causes of action, standards, and methods to regulate the industry. The Iowa Supreme Court articulated the clearest justification of this position in *Moore v. Vanderloo*, resting its holding on the following rationale:

> 1. There is no satisfactory standard of care by which to measure an educator's conduct.
>
> 2. The cause of the student's failure to learn is inherently uncertain, as is the nature of damages.
>
> 3. Permitting such claims would flood the courts with litigation

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N.W.2d 679 (Wis. 1979). *See also* Joel E. Smith, Annotation, *Tort Liability of Public Schools and Institutions of Higher Learning for Educational Malpractice*, 1 A.L.R. 4th 1139 (1980).

75. *See Paladino*, 454 N.Y.S.2d 868.

76. *Id.*

77. *Id.* at 872.

78. *Id.* at 873.

> and would thus place a substantial burden on educational institutions.
>
> 4. The Courts are not equipped to oversee the day-to-day operation of educational institutions.[79]

Furthermore, apologists of the academic abstention doctrine argue that to put the question to the fact finder would present similar issues and lead to even more vague and uncertain judicial precedent.[80]

As discussed above, contract claims fare even worse and provide less guidance than fraud claims in that they are seldom addressed on the merits. Some promises, made by an institution and its representatives, can be binding,[81] and certain institutional promises must be kept to avoid contractual breach.[82] However, to the extent that a court has considered a contract claim against an institution, the court's determination typically rests on a fact-intensive inquiry—a slight deviation from the academic abstention doctrine. In *Ross v. Creighton*, the United States Court of Appeals for the Seventh Circuit held that if the court were required to make determinations of educational processes and theories, then the contractual claim would fail; but if the court could objectively conclude that the institution failed on its promises, then the claim could proceed.[83] While this decision recognizes a student's viable contract cause of action against the institution, it does so in the narrowest of circumstances and still greatly disfavors the plaintiff.

For instance, a successful fraudulent or negligent misrepresentation claim hinges on the plaintiff's ability to prove the defendant institution's *scienter*—intent or knowledge of wrongdoing.[84] A standard element of a

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79. WILLIAM A. KAPLIN & BARBARA A. LEE, THE LAW OF HIGHER EDUCATION 104–05 (4th ed. 2007) (citing Moore v. Vanderloo, 386 N.W.2d 108, 114–15 (Iowa 1986)).

80. See Linehan, *supra* note 21, at 764; McJessy, *supra* note 69, at 1774–80.

81. *See* CenCor Inc. v. Tomlan, 868 P.2d 396, 399 (Colo. 1994).

82. *See* Ross v. Creighton Univ., 957 F.2d 410, 417 (7th Cir. 1992).

83. *Id.*

84. In fact, the full elements of the claim require that: (1) the defendant made a false misrepresentation; (2) the defendant acted with intent to deceive; (3) the misrepresentation was directed at a particular person; (4) the misrepresentation was material; and (5) the plaintiff's action in reliance upon the misrepresentation resulted in the plaintiff's injury. *See* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 107 (5th ed. 1984). *See also* Linehan, *supra* note 21, at 765 n.76 ("Most states apply the traditional common law elements of fraudulent misrepresentation, though with subtle variations.") *See, e.g.*, Draughon's Bus. Coll. v. Battles, 68 So. 2d 58, 61 (Ala. Ct. App. 1953) (holding that for a false promise by a school to constitute actionable fraud, the promise must be made with the intent to deceive, no intention to fulfill the promise at the time the promise is made, and injury resulting therefrom); Delta Sch. of Commerce, Inc. v. Wood, 766 S.W.2d 424, 426 (Ark. 1989) (noting that the essential elements of an actionable fraud are false, material representation; *scienter*; an intention that the plaintiff should act on such representation; justifiable reliance by the plaintiff on the representation; and damage resulting therefrom); Lidecker v. Kendall Coll.,

prima facie case of fraud, this knowledge is proved when the plaintiff demonstrates that the defendant "kn[ew] or believe[d] the matter [wa]s not as he represent[ed] it to be."[85] As is often the case, direct evidence of the defendant's knowledge of wrongdoing is rarely available to the plaintiff, but the plaintiff must prove this element in order for the plaintiff's claim to survive. As if that burden of proof was not difficult enough to satisfy, a plaintiff bringing a fraudulent misrepresentation claim may recover for pecuniary loss only if three requirements are met: (1) the plaintiff relies on the misrepresentation,[86] (2) the reliance upon the misrepresentation is justifiable,[87] and (3) this reliance is not deemed justifiable unless the matter misrepresented is material to case.[88] Thus, the knowledge requirement, coupled with the reliance and proximate cause elements of this claim, impose a high burden on the plaintiff, which severely limits the plaintiff's chances of success with this claim.

Similarly, even though the judicial tenet of academic abstention is a wise position for the judiciary to take, it offers no viable remedies for plaintiffs in tort or contract, thereby achieving no justice for victims of misrepresentations made by proprietary education institutions. A "new" cause of action must be made available to those who have been injured by dishonest proprietary colleges and universities—at the least to place these plaintiffs on equal footing with defendants. As postsecondary education increasingly resembles a product-driven industry, the accountability standards that the law applies to for-profit ventures to protect consumers should also apply in the same fashion, and with the same force, to proprietary education institutions.

III. THE IMPORTANCE OF DISCLOSURE

The insistence on transparency in our society may seem to be a recent phenomenon, but in reality it has been a legislative goal since as early as 1938, when the passage of the Federal Food, Drug, and Cosmetic Act[89] gave consumers the benefit of seeing what they were actually ingesting though modern food label requirements. President John F. Kennedy took this principle a step further with his Consumer Bill of Rights speech to Congress in 1962. Most notably, President Kennedy championed the right of the consumer to be informed, including the consumer's right "to be pro

550 N.E.2d 1121, 1124 (Ill. App. Ct. 1990) (holding that the elements of common law fraud include a false statement or omission of material fact, which is made by defendant with the intent to deceive and induce the plaintiff to act, and justifiable reliance by the plaintiff on the "false statement or omission, and an actual injury to [the] plaintiff as a result of the misstatement or omission").

85. RESTATEMENT (SECOND) OF TORTS § 526(a) (1977).

86. *Id.* at § 537(a).

87. *Id.* at § 537(b).

88. *Id.* at § 538.

89. *See generally* 21 U.S.C. § 301–99 (2012).

tected against fraudulent, deceitful, or grossly misleading information, advertising, labeling, or other practices, and to be given the facts he [or she] needs to make an informed choice."[90]

To be sure, there are drawbacks associated with too much disclosure, which can result in decreased consumer attention to the disclosed information.[91] Additionally, more disclosure does not always alert consumers to fraudulent or unethical behaviors, as was exposed during the housing market collapse.[92] However, in the educational setting, disclosing vital information about an institution aids students in deciding which school to attend and may even improve student matriculation.[93] A randomized, controlled study tested whether sending high-achieving (test scores in the top ten percent), low-income (family income in the lowest quarter) students more information changed their enrollment patterns.[94] The results of the study, which gathered information on nearly forty thousand students from this specific demographic, demonstrate that for these students more information about a college choice and cost positively affected the application their behavior and drastically improved their likelihood of admission.[95] Furthermore, the students who received more information submitted more applications, were more likely than other students in a control group to apply to "peer" colleges—schools where other students had similar levels of preparation—and were accepted by more colleges, including nearly a seventy-eight percent likelihood of being accepted by a "peer" college over the con-

90. President John F. Kennedy, Special Message to the Congress on Protecting the Consumer Interest (Mar. 15, 1962), *available at* http://www.presidency.ucsb.edu/ws/?pid=9108.

91. *See, e.g.*, Bikram Ghosh & Michael R. Galbreth, *The Impact of Consumer Attentiveness and Search Costs on Firm Quality Disclosure: A Competitive Analysis*, 59 MGMT. SCI. 2604 (2013).

92. *See* U.S. DEPT. OF THE TREASURY, REFORMING AMERICA'S HOUSING MARKET: A REPORT TO CONGRESS (2011), *available at* http://www.treasury.gov/initiatives/documents/reforming%20america's%20housing%20finance%20market.pdf.

93. Beckie Supiano, *A Low-Cost Way to Expand the Horizons of High-Achieving, Low-Income Students*, CHRON. HIGHER EDUC. (Mar. 29, 2013), http://chronicle.com/article/A-Low-Cost-Way-to-Expand-the/138227/. The view that more information aids students and their families in making the decisions about post-secondary education may have even become commonplace. *See* Michael Garanzini, *The Devil Is in the Performance-Based Details*, CHRON. HIGHER EDUC. (Oct. 7, 2013), http://chronicle.com/article/Th e-Devils-in-the/142153/ ("Everyone agrees that students and parents should have more information about the institutions they are considering, that college needs to be more affordable, and that degree completion has real value in the marketplace.").

94. *See* Supiano, *supra* note 93.

95. Caroline Hoxby & Sarah Turner, *Expanding College Opportunities for High-Achieving Low Income Students* (Stanford Inst. for Econ. Policy Research, Discussion Paper No. 12-014), *available at* http://siepr.stanford.edu/?q=/system/files/shared/pubs/papers/12-014paper.pdf.

trol group.[96] Because the institution a student selects to attend for his or her postsecondary instruction is universally regarded as an important decision, it is essential that students have more information available to them to facilitate this process.[97]

A. The Insufficiency of Current Measures to Regulate Proprietary Education Institutions

Under the oversight of Title IV mechanisms, the present model for the regulation of all postsecondary institutions—proprietary and non-proprietary—is often referred to as "the triad," consisting of the Department of Education, state regulatory bodies, and accreditation agencies.[98] Each body has a principal function in this relationship: (1) the Department of Education authenticates institutional eligibility for Title IV funding[99] and certifies accreditation agencies;[100] (2) state entities regulate postsecondary institutions through a variety of means, including regulatory boards and consumer protection laws;[101] and (3) accreditation agencies verify that postsecondary institutions have met a minimum standard of quality to receive certification to operate within a state or territory.[102] For every postsecondary institution, the triad's blessing is essential to the school's operation, because Title IV funding is available only to postsecondary institutions accredited by an agency certified by the Department of Education.[103] With regard to proprietary schools, however, the sanctions and fines that the triad, through the Department of Education, can impose on these institutions does little to deter unscrupulous business practices, and none provides a forum for a private right of action for a student who claims to have been harmed by a proprietary college or university.[104] Furthermore,

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96. *See id. See also* Supiano, *supra* note 93.

97. *See* Supiano, *supra* note 93. "'This is a huge decision for students, choosing which college [to attend],' Ms. Hoxby said. 'The goal is not to sway high-achieving, low-income students to go to a particular kind of college,' she said. It's to make sure they are as well informed as their more privileged peers." *Id.*

98. *See* Taylor, *supra* note 29, at 768.

99. U.S. GOV'T. ACCOUNTABILITY OFFICE, T-HEHS-96-158, HIGHER EDUCATION: ENSURING QUALITY EDUCATION FROM PROPRIETARY INSTITUTIONS (1996), *available at* http://www.gao.gov/assets/110/106522.pdf (statement of Cornelia M. Blanchette before the Subcommittee on Human Resources and Intergovernmental Relations, United States House of Representatives).

100. *Id.* at 4–5.

101. *Id.* at 5.

102. *Id.* at 5–6.

103. *See* Taylor, *supra* note 29, at 768.

104. *See, e.g.*, *Enforcement of Federal Anti-Fraud Laws in For-Profit Education: Hearing Before the H. Comm. on Education and the Workforce*, 109th Cong. 9 (2005) (statement of Rep. Maxine Waters, Member, H. Comm. on Educ. and the Workforce) ("[T]he school doing the defrauding may be allowed to pay a few cents on the dollar to settle claims with the Department, or placed on reimbursement status so that they have

accrediting agencies have a disincentive to revoke an institution's accreditation because their "income-stream is directly determined by the number of schools they accredit."[105]

To be sure, the Department of Education's regulatory failures are more complex than can be dealt with in this article, but bear discussion. In 2010, the Department valiantly attempted to modernize the triad model with the promulgation of its Program Integrity Rules,[106] as the result of an extensive review of the industry by the Senate Committee on Health, Education, Labor and Pensions, as well as the Government Accountability Office.[107] These rules recognize frauds perpetuated by any postsecondary institution in four areas: (1) marketing practices, (2) value of a degree, (3) financial aid practices, and (4) compensation of employees based on enrollment.[108] Similarly, in June of 2013, the Department of Education announced that it would again propose revised Gainful Employment Rules,[109] which would allow the triad to close down programs that fail to measure up as good financial value for students.[110]

Adding on existing disclosure requirements,[111] the Program Integrity Rules do a number of things right. For example, the rules strengthen existing regulations governing misrepresentation in advertising materials by broadening the definition of misrepresentation to include both direct and

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to wait 45 days for payment of financial aid."). The Department's promulgation of the Program Integrity Rules clearly intends to hit a moving target, but inevitably misses the mark.

105. *See id.* at 32.

106. *See* 34 C.F.R. §§. 668.11–668.28 (2013).

107. *See* Harkin *supra* note 36, at 8–9.

108. *See* Press Release, U.S. Dep't of Educ., Obama Administration Proposes Student Aid Rules to Protect Borrowers and Taxpayers; Key Elements of Gainful Employment on a Separate Track (June 16, 2010), *available at* http://www.ed.gov/news/press-releases/obama-administration-proposes-student-aid-rules-protect-borrowers-and-taxpayers-.

109. The Gainful Employment Rules, which are in the process of being revised at the time of publication of this article, are detailed in the next section of the article. *See infra* notes 116, 126, and 135.

110. This announcement came after the proffered Gainful Employment regulations were struck down by the United States District Court for the District of Columbia in March 2013. *See* Ass'n of Private Coll. & Univ. v. Duncan, 870 F. Supp. 2d 133 (D.D.C. 2013). *See also* Allie Bidwell, *Judge Refuses to Restore Vacated Provisions of 'Gainful Employment' Rule*, CHRON. HIGHER EDUC. (Mar. 20, 2013), http://chronicle.com/article/Judge-Refuses-to-Restore/138029/; Blumenstyk, *supra* note 14.

111. *See* Hazel Glenn Beh, *Student Versus University: The University's Implied Obligations of Good Faith and Fair Dealing*, 59 MD. L. REV. 183, 194 (2000) ("Congress imposes numerous disclosure requirements on postsecondary schools receiving federal funds, including the requirement to provide all students with general descriptive information and information regarding the nature of the program, its costs and its financial aid terms, crime data, and student-athlete consumer information.") (citations omitted).

indirect statements of an "erroneous, false, or misleading nature."[112] Effectively, these new rules hold eligible institutions "liable not only to a prospective student hearing an advertisement *but also* to a prospective student who did not hear the advertisement directly from the institution, but instead learned about the false advertisement from a secondary source."[113] The new rules also attempt to compel bolder disclosure requirements.[114] Previous regulations established rules against a limited set of misrepresentation types: false representation of accreditation status, a student's ability to qualify for professional licensure, a student's ability to transfer credits, and a school's overstatement of employment opportunities after graduation.[115]

The new regulations, however, fall short in many regards; for instance, they merely utilize more specific language to require schools to make various disclosures regarding accreditation and only when asked.[116] Additionally, the New York County Supreme Court recently examined the rules, holding that their interpretation by a non-government agency, *i.e.* "a national bar association akin to a private self-regulatory organization, receiving a delegation of authority" from the Department of Education, does not make the interpreting party an "official department, division, commission or agency of the United States."[117] With this decision, the court underscores

112. *See* Auster, *supra* note 38, at 650.

113. *Id*.

114. *See* 34 C.F.R. § 668.41 (2013).

115. *See* Auster, *supra* note 38, at 651.

116. *See* Program Integrity Issues, 75 Fed. Reg. 34,806, 34,835 (June 18, 2010). *See also* Auster, *supra* note 38, at 652 ("The rules expand the current provision covering disclosure of examination requirements for receiving a local, state, or federal license, mandates disclosure of whether the course work completed at the school qualifies a student to meet employment requirements, and clarifies conditions under which credits from another institution will be accepted.") (citations omitted). *But see* Nat'l Ass'n of Coll. & Univ. Attorneys, Subpart Q – Gainful Employment (GE) Programs (Discussion Draft 2013), *available at* http://www.nacua.org/documents/GainfulEmploymentRule_DraftLanugage.pdf (including a metric considering loan-default, and measuring the repayment rates of a postsecondary education program's entire "portfolio" of loans, particularly for those programs that experience high dropout rates). Both proponents and critics of the new draft believe that the proposed language is more rigorous with regard to closing loopholes and is more expansive in its scope of application—applying to over 11,000 proprietary education schools, vocational schools, and community colleges, more than double those covered by the standards from two years ago—than the prior draft. *See* Paul Fain, *Further on Gainful Employment*, INSIDE HIGHER ED (Nov. 12, 2013), http://www.insidehighered.com/news/2013/11/12/feds-release-tighter-proposed-language-gainful-employment-rules#ixzz2kSwwgk7g. While this Article primarily contemplates considerations such as student loan default under the Gainful Employment Rules in the context of proprietary education, it must be said that even community colleges are on notice to pare down the number of graduating students who default on their loans. *See, e.g.*, Mike James, *ACTC Worries about Student Loan Default Rate*, THE INDEP. (Dec. 8, 2013), http://www.dailyindependent.com/local/x853089297/ACTC-worried-about-student-default-rate.

117. Gomez-Jimenez v. N.Y. Law Sch., 943 N.Y.S.2d 834, 841–42 (N.Y. Sup. Ct.

the disconnect between the Department of Education and the accrediting bodies it certifies.

Moreover, these new regulations lack the teeth to root out the most concerning deceptive trade practices of some proprietary education institutions—financial aid manipulation and the misrepresentation of the valuation of a degree. Even though the Department of Education identified these areas as requiring the highest level of transparency,[118] and thus attempted to develop mandatory reporting and disclosure guidelines for all proprietary education institutions,[119] the disclosure and reporting requirements are treated more like guidelines than law under the new rules. Ensuring that all information is disseminated uniformly is a vital step toward allowing prospective students to make important comparisons of their choices in postsecondary education as well as toward avoiding manipulation of the facts by all unscrupulous postsecondary institutions.

Although the guidelines established by the Program Integrity Rules attempt to standardize the means by which schools report graduation rates, placement rates, program costs, average student debt, and occupation profiles, allowing students to compare costs and programs across various schools, the rules provide no meaningful guidance on how the standardization of disclosure and reporting is to be accomplished.[120] Furthermore, the new rules have been in effect since July of 2011, but as of August of 2013, the Department of Education has yet to release a standardized form that streamlines the disclosure and reporting process.[121] Additionally, the Department of Education has explicitly stated that under the rule, schools have flexibility in how they choose to report data, but that they must report to the Department of Education as to how they intend to make the calculation.[122]

While this approach takes into account "the concerns made during the comment period and will allow schools to utilize an approach already ap-

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(2012).

118. *See* 34 C.F.R. § 668.72 (2013). S*ee also* 34 C.F.R. § 668.74 (2013).

119. 34 C.F.R. § 668.6 (2013).

120. *See id. See also* Auster, *supra* note 38, at 653 n.153 ("The DOE's discussion clarifies that the disclosure requirement applies to all schools offering programs for gainful employment, therefore all schools that qualify for Title IV funding under §§ 102(b)-(c), 101(b)(1) of the Higher Education Act. . . . These sections define schools eligible for Title IV funds, which includes proprietary schools."); Program Integrity Issues, 75 Fed. Reg. 66,832, 66,948–49 (proposed Oct. 29, 2010) (requiring occupation profiles to be linked to the website O*Net, established by the Department of Labor, and to provide information about particular jobs, the training required, and the expected salaries).

121. Program Integrity Issues, 75 Fed. Reg. 66,832, 66,833, 66,836 (Oct. 29, 2010). Not surprisingly, the Department employs non-enforcing and circular language under the rule; until the Department of Education develops a form, schools must comply with the regulations as they are written.

122. *Id.* at 66,836.

proved by states or accrediting bodies,"[123] it suggests that the standardization of disclosure and reporting is of nominal importance to the Department of Education.[124] This lack of follow-through highlights the triad regulatory model's shortcomings. The triad should cede to a model that includes nonpartisan governmental accreditation entities, which lack pecuniary interest in the accreditation of any postsecondary institution and are equipped to enforce penalties on schools that do not follow the Department of Education's rules, such as the Program Integrity Rules. This new model should also prioritize standardizing the disclosure and reporting process in a way that the triad has failed to do.

B. The Role of Proprietary Education Institutions in the Student Loan Default Crisis

Even after the Department of Education passed its Program Integrity Rules in 2010, the student loan defaults have continued to balloon.[125] This fact, taken together with the proprietary education industry's disproportionate share of federal aid dollars, underscores the need for greater scrutiny.[126] The proprietary education industry's reliance upon Title IV funding may be caused by the substantially higher percentage of students at proprietary colleges and universities that take out loans to finance their education than do their peers at traditional postsecondary institutions.[127] Because of this in-

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123. Auster, *supra* note 38, at 656 n.156.

124. The Department's deference to already-extant reporting mechanisms is, by its nature, not made in the interest of uniformity. *See id. See also* Blumenstyk, *supra* note 14; Bidwell, *supra* note 110. *But see* Beh, *supra* note 111, at 193–95.

125. *See* Andy Thomason, *Student-Loan Default Rates Continue Steady Climb*, CHRON. HIGHER EDUC. (Oct. 1, 2013), http://chronicle.com/article/Student-Loan-Default-Rates/142009/; Bill Hardekopf, *More Than Half of Student Loans Are Now in Deferral or Delinquent*, FORBES (Feb. 1, 2013, 10:36 AM), http://www.forbes.com/sites/moneybuilder/2013/02/01/alarming-number-of-student-loans-are-delinquent/. *See also* Jane Glickman, *Student Loan Default Rates Increase*, U.S. DEPT. OF EDUC. (Sept. 13, 2010), http://www.ed.gov/news/press-releases/student-loan-default-rates-increase-0. For an implicit discussion of why student loan default rates have increased, see Eric A. Hanushek, *Expenditures, Efficiency, and Equity in Education: The Federal Government's Role*, 79 AMER. ECON. REV. 46 (1989).

126. Program Integrity: Gainful Employment, 75 Fed. Reg. 43,616, 43,618 (proposed July 26, 2010) (indicating that in 2009, the five largest for-profit institutions derived seventy-seven percent of their revenue from federal student aid programs). *See also* Nicholas R. Johnson, *Phoenix Rising: Default Rates at Proprietary Institutions of Higher Education and What Can Be Done to Reduce Them*, 40 J.L. & EDUC. 225, 269 (2011) ("In for-profit education, every segment of the institution is incentivized to enroll as many students as possible—recruiters are paid on volume, instructors are compensated based on completions, and executives and shareholders are paid based on growth.").

127. Allison Sherry, *Pass or Fail? For-Profit Colleges Make the Grade In Reaching At-Risk Students, But Questions Arise Over Student Loan Defaults and Job Prospects*, THE DENVER POST, Jan. 17, 2010, at A1 (proposing that ninety-four percent of

creased borrowing, students who graduate from proprietary colleges and universities have substantially more debt than graduates of traditional post-secondary institutions.[128] Proprietary institutions, however, have no skin in the game, because they do not bear the risk of loss if their students default on their loans.[129] If the government cannot ultimately collect on Title IV loans, the government is forced to absorb the cost. For instance, the Federal Family Education Loan Program holds the government responsible for ninety-seven percent of the cost of loans in default,[130] and the Direct Loan program requires that the government pay the full cost of unpaid principal and accrued interest on defaulted loans.[131] Ultimately, taxpayers are stuck with the bill if the government cannot recover on defaulted student loans.[132]

Of the $16 billion in federal loans lent to students at proprietary schools in 2007, over forty percent of these student loans are or will be in default—equating to well over $6 billion.[133] The cost of the proprietary education industry's use of Title IV funds exceeds the cost of defaulted loans paid with taxpayer dollars. Perhaps more alarming still is the fact that this data is six years old, before the wheels fell off the student loan cart. One possible reason for the rise in student loan defaults is that the entire proprietary education industry has failed to ensure its students' preparation for gainful employment.[134] For instance, the persistent oversupply of labor saturates the workforce with the same skill-sets and perpetuates the student loan default rates as well as unemployment rates. To paraphrase Judge Richard Posner, if an optimal ratio of loan debt to income actually exists, as the government

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those enrolled at proprietary schools take out federal loans to pay for tuition, as compared with only one third of students at traditional public colleges).

128. Johnson, *supra* note 126, at 232. *See also* Daniel Luzer, *How are the For-Profits Doing?*, WASH. MONTHLY (July 30, 2012, 6:23 PM), http://www.washingtonmonthly.com/college_guide/blog/how_are_the_forprofits_doing.php ("Ninety-six percent of for-profit students take out student loans, according to the most recent U.S. Department of Education data. In comparison, [thirteen percent] of students at community colleges, [forty-eight percent] at [four]-year public, and [fifty-seven percent] at [four]-year private non-profit colleges borrow money to pay for school.").

129. *See* S. HEALTH, EDUC., LABOR & PENSIONS COMM., 111TH CONG., SUBPRIME GOES TO COLLEGE 1 (testimony of Steven Eisman, Portfolio Manager, FrontPoint Financial Services Fund), *available at* http://help.senate.gov/imo/media/doc/Eisman.pdf. It has been suggested that non-proprietary schools do not typically engage in the same fraudulent behavior as their proprietary peers, despite not having much to lose when their students default on loans, because of their historically greater reliance on public goodwill. *See id. See also* Blumenstyk, *supra* note 14; Cellini & Goldin, *supra* note 63.

130. *Cohort Default Rates*, FINAID.COM, http://www.finaid.org/loans/cohortdefaultra tes.phtm l (last updated Dec. 21, 2010). *See also* SCOTT, *supra* note 16.

131. *See* SCOTT, *supra* note 17.

132. *See* Sherry, *supra* note 127, at 1. *See also* Johnson, *supra* note 126, at 236.

133. Sharona Coutts, *Setting the Record Straight On Our Student Default Rate Story*, PROPUBLICA (Dec. 24, 2009 2:40 PM), http://www.propublica.org/article/setting-the-record-straight-on-our-student-default-rate-story-1224..

134. Johnson, *supra* note 126, at 267.

says that there is, then why don't at least some proprietary schools work to achieve this level without government intervention?[135]

The Gainful Employment Rules are an integral part of the Program Integrity Rules. In order to continue to receive federal funding, under the Gainful Employment Rules, a postsecondary institution is required to meet three requirements: (1) ensure that at least thirty-five percent of former students are paying down their loans, (2) make certain that former students do not pay more than thirty percent of their discretionary income on loan payments, (3) make sure that former students do not spend more than twelve percent of their total income on loan payments.[136] In July 2011, several companies that own proprietary institutions sued to prevent the Department of Education from issuing the rules.[137] In a favorable outcome for the proprietary education industry, the United States District Court for the District of Columbia held that the debt measures comprising the Gainful Employment Rules "lack[ed] a reasoned basis" and were "arbitrary and capricious."[138] While a strong argument can be made that the thirty-five percent rule is arbitrary, it is incontrovertible that the Department of Education has the authority to regulate the proprietary education industry in order prevent fraud, but has failed to meaningfully do so.

In *Association of Private Colleges and Universities v. Duncan*, the court held that the Department fell short in justifying one prong of the three-prong test used to evaluate job-focused higher education programs:

> Under the rules, programs are evaluated on three measures: a debt-to-earning ratio (that is, how big [a student's] loans are compared to how much money [that student is] making), a debt-to-discretionary-earnings ratio, and a loan repayment rate. The first two measures were valid . . . because the department had presented research backing up the specific thresholds they chose. The [thirty-five] percent repayment-rate threshold, by contrast, was essentially chosen as a number that would land on some . . . middle ground between identifying too many and too few programs. This is arbitrary . . . and since the three measures work together in determining eligibility for financial aid, the whole regulatory apparatus is suspended.[139]

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135. Richard Posner, *The Controversy Over For-Profit Colleges*, BECKER-POSNER BLOG (June 20, 2010), http://www.becker-posner-blog.com/2010/06/the-controversy-over-forprofit-collegesposner.html.

136. Luzer, *supra* note 128.

137. *See* Complaint, Ass'n of Private Coll. & Univ. v. Duncan (D.D.C. 2012) (No. 11–1314), 2011 WL 2898945. *See also* Ass'n of Private Coll. & Univ. v. Duncan, 870 F. Supp. 2d 133 (D.D.C. 2012).

138. *Duncan*, 870 F. Supp. 2d at 137.

139. Kevin Carey, *Let's Put "Gainful Employment" Ruling in Perspective*, CHRON. HIGHER EDUC. (July 2, 2012), http://chronicle.com/blogs/brainstorm/lets-put-gainful-

Whether or not this number is arbitrary, it tends to favor the proprietary education industry. Because the plaintiffs succeeded in their quest for an injunction, the Department of Education will not be able to implement penalties under the Gainful Employment Rules, leaving dishonest proprietary colleges and universities free to continue to take advantage of federal student aid without regard to the debt levels and repayment rates of their former students.[140] In light of the court's decision in *Duncan*, it is vital that new regulations and remedies emerge to prevent a dire situation from worsening.[141]

IV. THE CASE FOR ADOPTING A FIDUCIARY DUTY MODEL IN THE RELATIONSHIP BETWEEN PROPRIETARY EDUCATION INSTITUTIONS AND THEIR STUDENTS

Postsecondary institutions have all but abandoned the *in loco parentis* doctrine—the idea that, by placing the school in the position of parents, the school may exert untrammeled authority over the student—that predominated postsecondary education before 1972.[142] Increasingly, postsecondary institutions, especially proprietary education institutions, treat students more like the adults and consumers they are.[143] Yet, the judiciary has been reluctant to withdraw the protection it has long afforded all postsecondary institutions, not just proprietary schools, against holding these schools to the same standards of care that are applied to business or other non-educational organizations. At the same time, proprietary education institu

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employment-ruling-in-perspective/49203.

140. Daniel Luzer, *Arbitrary Research Standards for For-Profit Colleges*, WASH. MONTHLY (July 2, 2012, 5:19 PM), http://www.washingtonmonthly.com/college_guide/blog/arbitrary_research_standards_f.php.

141. At the time of publication of this article, the White House released information on its plan to make college more affordable. Press release, Office of the Press Sec'y, The White House, Fact Sheet on the President's Plan to Make College More Affordable: A Better Bargain for the Middle Class (Aug. 22, 2013), *available at* http://www.whitehouse.gov/the-press-office/2013/08/22/fact-sheet-president-s-plan-make-college-more-affordable-better-bargain-. It is unclear how these ratings would be implemented. *See* Scott Jaschik, *Obama's Ratings for Higher Ed*, INSIDE HIGHER ED (Aug. 22, 2013, 3:44 AM), http://www.insidehighered.com/news/2013/08/22/president-obama-proposes-link-student-aid-new-ratings-colleges. However, one thing is certain: the like-treatment of proprietary institutions and non-proprietary institutions ignores the fundamental differences between the two, which can only perpetuate the problem contemplated by this article.

142. *See* KAPLIN & LEE, *supra* note 79, at 16. *See also* Theodore C. Stamatakos, *The Doctrine of* In Loco Parentis, *Tort Liability, and the Student-College Relationship*, 65 IND. L.J. 471 (1990); Perry A. Zirkel & Henry F. Reichner, *Is the* In Loco Parentis *Doctrine Dead?*, 15 J.L. & EDUC. 271 (1986).

143. *See* Kerry B. Melear, *From* In Loco Parentis *to Consumerism: A Legal Analysis of the Contractual Relationship Between Institution and Student*, 40 NASPA J. 124 (2003); Susan L. Pollet, *Is* In Loco Parentis *at the College Level a Dead Doctrine?*, 4 N.Y. L.J. 228 (2002).

tions, as corporate entities, must maximize profits for their shareholders; this distinguishes the corporate education model and nonprofit education model and underscores the need to treat each model separately under the law.

It is also clear that the traditional causes of action that students bring against proprietary educational institutions are inadequate to provide an effective and equitable remedy to student victims of deceptive trade practices. Because the postsecondary institutions themselves have abandoned the *in loco parentis* approach, it is time for the judiciary to respond—by protecting students against injury at the hands of dishonest colleges and universities—especially in the context of the student-proprietary-education-institution relationship.

The most sensible remedy is to apply a limited fiduciary duty to proprietary education institutions.[144] In *Schneider v. Plymouth State College*, which involved a public, non-proprietary institution, the New Hampshire Supreme Court recognized a limited fiduciary duty, noting that such duty "'may exist under a variety of circumstances, and does exist in cases where there has been a special confidence reposed in one who, in equity and good conscience, is bound to act in good faith and with due regard to the interests of the one reposing the confidence.'"[145] The court clarified that the fiduciary relationship existing between a postsecondary institution and its students did not rest on the doctrine of *in loco parentis*, which the court reserved for the relationship between primary and secondary schools and their students.[146] Rather, the court distinguished the relationship between a postsecondary institution and its students as a unique "professional relationship of trust and deference, rarely seen outside the academic community".[147]

Even though the "confidence" standard applied by the New Hampshire Supreme Court is mostly clear and provides a level playing field for both plaintiff and defendant to dispute the existence of a fiduciary relationship, this standard has not yet gained traction in other courts. This may be, in part, because the New Hampshire Supreme Court essentially carved out a limited fiduciary duty for application in the postsecondary education context. Instead of typical fiduciary duty labels—such as duties of obedience, loyalty, care, and disclosure—the court recognizes a general fiduciary duty that implies good faith, fair dealing, and transparency.[148]

144. Most notably, fiduciary duties include good faith and fair dealing between the relevant parties. *See generally* RESTATEMENT (THIRD) OF AGENCY §§ 8.01–8.12 (2005).

145. Schneider v. Plymouth State Coll. 744 A.2d 101, 105 (N.H. 1999) (quoting Lash v. Cheshire Cnty. Sav. Bank, 474 A.2d 980 (N.H. 1984) (quotation marks and formatting omitted)).

146. *Id.* at 106.

147. *Id.*

148. *Id.* While the court also addressed the plaintiff's Title IX claims, the court's

Critics argue that creating a fiduciary duty, which proprietary institutions would owe their students in addition to the duties that proprietary institutions already owe their investors, creates conflicting duties for the institution.[149] However, applying the New Hampshire Supreme Court's general duty to the proprietary education context would avoid conflicts that might arise among the duties that proprietary institutions owe their students, their shareholders, and the public. This is because good faith, fair dealing, and transparency—essential to good business practices and to the general duty to students and the public—are important intangibles which an investor must consider before he lends his funds to an enterprise. While this is precisely the kind of fiduciary duty that should apply to proprietary postsecondary education institutions, the fact that other courts have not done so seems to stem from the judiciary's continued reluctance to compare traditional postsecondary institutions to business organizations.[150]

Outside of the traditional business organizational setting, however, there may be no better place for the application of a fiduciary duty than in the proprietary education context. In the first place, proprietary education institutions are most often organized with the Secretary of State's office as a corporation, as Part I of this article describes. By definition, these institutions exist to make profits. In the case of the publicly traded, proprietary education institutions—of which, as of 2013, there are fourteen nationwide[151]—there are additional pressures to increase shareholder value and maintain high stock prices.[152] These ever-present market pressures can lead to bad behavior from proprietary institutions against consumers who lack adequate protection.

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holding as to the existence of the fiduciary duty clearly stands on its own.

> [O]ur conclusion that a fiduciary relationship existed between the defendants and the plaintiff does not rest on the *in loco parentis* doctrine. . . . '[A] fiduciary relationship exists whenever special confidence has been placed in another,' and . . . '[a] breach of a fiduciary relationship results whenever influence has been acquired and abused or confidence has been reposed and betrayed.' These concepts are not beyond the ability of the average layperson to understand.

See id at 105–07 (citing State v. Hungerford, 697 A.2d 916, 921 (N.H. 1997)).

149. *See* Salmon, *supra* note 67.

150. *See generally* Valente v. Univ. of Dayton, 438 F. App'x 381 (6th Cir. 2011) (holding that a law school did not breach a contract with a student in connection with a disciplinary proceeding).

151. *See* Harkin, *supra* note 36, at 4. *See also* Auster *supra* note 38.

> The actual revenue percentage reported to the DOE is 81.3%, reflecting the ability of schools to exclude increased distributions of Stafford Loans from revenue calculations. Congress' initial requirement that a school must have at least fifteen percent of its revenue from sources other than Title IV funds was reduced to ten percent in 1998, creating what is called the 90/10 rule.

Id. at 638 n.37 (citations omitted).

152. RUCH, *supra* note 31, at 3.

In addition, there is an increasing tendency to find the existence of a fiduciary relationship in diverse but seemingly quotidian contexts:

> [Fiduciary relationships] include the relationship between an employer and employee, brothers and sisters, husband and wife, persons engaged to be married, children and parents, attorney and client, officers of the corporation and stockholders, joint purchasers, joint owners selling jointly owned property, partners, joint venturers, physician and patient, priest and parishioner, rabbi and congregation, principal and agent, and trustee and *cestui que* trust. . . . At least two courts have even found that close friends stand in such a relationship of trust and confidence as to require full disclosure of material facts.[153]

Our society places a high value on good faith and transparency. For example, under Section 13(a) of the Securities Exchange Act of 1934, a registered corporation under the Commission Rule is required to file an annual report of its financial condition as "necessary or appropriate in the public interest [or] for the protection of investors."[154] Of course the analog here is that the securities investor is to the corporation what the student-consumer is to the proprietary school, but this analogy is not as far afield as it may initially seem. In *SEC v. W.J. Howey Co.*, the Supreme Court of the United States provided a three-pronged definition of a security: (1) "an investment of money," (2) "in a common enterprise," (3) "with profits to come . . . from the efforts of others."[155] Given that the second prong of this test—common enterprise—is understood to mean "one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties,"[156] it is not unreasonable to conclude that student-consumers, bringing their large sums of grant and loan money to a proprietary institution, deserve the same treatment as a potential shareholder. Their future is as tied-up with the success of the proprietary institution and the valuation of its degree as a purchaser of securities is with the valuation of its company shares. That said, the burden may be too great to impose typical registration requirements for the sale of securities on proprietary education institutions.

This article does not claim that proprietary colleges and universities should be subject to the same stringent security registration requirements as corporations; however, as Part II of this article described, a proprietary ed-

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153. *See* Nicola W. Palmieri, *Good Faith Disclosures Required During Precontractual Negotiations*, 24 SETON HALL L. REV. 70, 127–28 (1993) (citations omitted) (discussing the ethical role standards play in the marketplace).

154. 17 C.F.R. § 240.13a–1 (2013); Securities Exchange Act of 1934, §13, 48 Stat. 881, 894–95; 15 U.S.C. § 78l(b) (2012).

155. SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

156. SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 (9th Cir. 1973).

ucation institution is organized around a corporate model, beholden to its shareholders, and not accountable to its students. If requiring a corporation to issue a prospectus to potential shareholders has become so uncontroversial as to be commonplace, then imposing fiduciary duties of disclosure, good faith, and fair dealing on corporate educational providers should be considered. For the law to begin to reflect the reality of the educational marketplace, a general fiduciary duty should apply to proprietary institutions.

V. A RECOMMENDATION

Writing proprietary education institutions out of Title IV eligibility would be a simple fix to the problems endemic to the industry, but it would throw the baby out with the bathwater. Proprietary colleges and universities do serve an important role in postsecondary education—though this is increasingly less the case as non-proprietary colleges and universities move into direct competition with them at significantly lower prices to students.[157] However, the bad deeds of too many proprietary institutions have proven costly to American taxpayers,[158] demanding more effective regulation of the proprietary education industry. This article merely recommends a state-based action plan which ensures that the student-consumer is fully informed before deciding to attend a proprietary educational institution and that remedies exists for student-consumer victims of proprietary educational institutions' deceptive trade practices. Below are three simple, transparent, best-practices for achieving this important policy goal.

A. Expand "The Triad"

To ensure that consumers have the information they need to make informed decisions before enrolling in proprietary education institutions, and viable venues to pursue remedies against institutions that engage in deceptive trade practices, the regulatory triad must be expanded. It is not enough that only the Department of Education, state regulatory bodies, and accrediting agencies govern the relationship between proprietary education insti-

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157. *See* Blumenstyk, *supra* note 14.

158. S. HEALTH, EDUC., LABOR & PENSIONS COMM., 112TH CONG., FOR PROFIT HIGHER EDUCATION: THE FAILURE TO SAFEGUARD THE FEDERAL INVESTMENT AND ENSURE STUDENT SUCCESS MAJORITY COMMITTEE STAFF REPORT AND ACCOMPANYING MINORITY COMMITTEE STAFF VIEWS (2012), *available at* http://www.help.senate.gov/hearings/hearing/?id=cdd6e130-5056-9502-5dd2-e4d005721cb2. *See, e.g.*, Peter Fenn, *For-Profit Colleges Use Taxpayer Dollars to Rip Off Students*, U.S. NEWS (July 31, 2012), http://www.usnews.com/opinion/blogs/PeterFenn/2012/07/31/for-profit-college s-use-taxpayer-dollars-to-rip-off-students; Eric Flack, *For-Profit Colleges Waste Billions in Taxpayer Money*, W.A.V.E. NEWS (Aug. 28, 2013, 2:17 PM), http://www.wave3.com/story/23279771/for-profit-colleges-accused-of-wasting-billions-in-taxpayer-money.

tutions and their students.[159] This conversation excludes two vital pieces; the triad must welcome state legislatures and the judiciary to the table. For example, given the debt that the federal government assumes in defaulted student loans,[160] it would be wise to use cooperative federalism—reserving money that would be spent by the federal government solely to shoulder the burden of regulating and cleaning up after proprietary schools, and offering it as a reward to state legislatures who enter the realm of proprietary education regulation more boldly. This would get the states on board with useful regulatory measures. The existing Program Integrity Rules cannot accomplish this task, as evidenced by the recent outcome of litigation challenging the rules.[161] But these rules should be a floor, not a ceiling. The states should enter the fray at this critical juncture. If the states do not have accreditation entities, they need to create such entities to ensure that compliance with the Department of Education's requirements for Title IV funding and other accreditation standards is regulated in a fair and disinterested manner. Furthermore, involving the judiciary by creating private causes of action that are more favorable to plaintiffs could deter the scrutiny-attracting, unscrupulous behavior of some proprietary institutions and encourage best practices to bring the schools that have strayed from their educational mission back into the fold.

B. Enact Narrowly Tailored Disclosure Legislation at the State Level

State legislatures across this country have enacted consumer protection legislation.[162] Now, they must enact substantive disclosure legislation that can be reasonably calculated to provide consumers with the information necessary to make informed decisions about attending proprietary institutions. At a minimum, this legislation should require the standardized publication of—or other means of conveying—key information: (1) annual student attrition, (2) annual student retention, (3) annual student persistence, (4) annual student degree and certificate completion rates, (5) transferability options for credits earned, (6) average student debt at the time of degree or certificate completion, and (7) average rate of employment in the field of training, tracking three months, six months, nine months, and one year from the date of degree or certificate completion. In order for this information disclosure to achieve the desired effect, information should be communicated in simple, clear terms. Ideally, these figures should convey

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159. *See* Taylor, *supra* note 29, at 768.

160. *See* S. HEALTH, EDUC., LABOR & PENSIONS COMM., *supra* note 129; SCOTT, *supra* note 17.

161. *See* Ass'n of Private Coll. and Univ. v. Duncan, 870 F. Supp. 2d 133 (D.D.C. 2012).

162. *See, e.g.*, IND. CODE § 24-5-0.5-1 (2013); KY. REV. STAT. ANN. § 367.120 (2013); N.Y. GEN. BUS. LAW § 349 (2013); S.C. CODE ANN. § 37-1-101 (2013); TEX. BUS. & COM. CODE ANN. § 17.12 (2013); W. VA. CODE. R. § 46A-6-101 (2013).

each item using a school-wide average and detail each item by individual programs of study. Given the expenditures of proprietary institutions on promotional and advertising materials,[163] it is not unreasonable to require this information to be provided to the consumer on each advertisement.

As the Department of Education has been unable to articulate a uniform method of doing so,[164] this article recommends that states develop standardized reporting methods requiring: (1) the disclosure be filed with the state accreditation board annually by June 30; (2) the state accreditation board compile the disclosure filings of all proprietary institution licensed to operate inside the state for the current school year; (3) the disclosure filings be arranged by the state accreditation board in a manner that allows the consumer to clearly compare and contrast the proprietary education institutions; (4) the compilation of disclosure filings be placed in a visible and centralized location on the state accreditation board's website, as well as on the website of all accredited proprietary institutions within the state, annually by July 31; (5) all proprietary education institutions include a state-agency-approved summary of the complete compilation of disclosure filings with any mailed, in person communication of, or printed promotional or advertising materials; and (6) an employee or agent of the proprietary education institution engaged in admissions, financial aid, recruitment, instruction or any related activity to explain the institution's disclosure filing to any and all current and prospective students in clear and non-confusing terms. That said, communicating all of the information required by the recommended legislation in non-print promotional or advertising materials places a high burden on the proprietary education institution. In the case of video or digital media promotions or advertising, this article recommends a simple solution: that the advertisement clearly articulate where the viewer may find important data about the advertising institution (*e.g.* annual student attrition rates, annual student degree and certificate completion rates, average student debt at the time of degree and certificate completion, and

163. Between 2007 and 2012, ten of the largest virtual proprietary K-12 schools have spent an estimated $94.4 million on advertisements. Greg Toppo, *Online Schools Spend Millions to Attract Students*, USA TODAY (Nov. 28, 2012), http://www.usatoday.com/story/news/nation/2012/11/28/online-schools-ads-public-/1732193/. Google's largest advertiser—at more than $400,000.00 in daily advertisements—is the University of Phoenix. Kaplan, Devry and ITT also rank among the twenty-five biggest advertisers on Google. A. Ananthalakshmi, *For-Profit Colleges Spend Big on Marketing While Slashing Other Costs*, REUTERS (Nov. 28, 2012), http://www.reuters.com/article/2012/11/28/net-us-forprofitcolleges-analysisidUSBRE8AR0FJ20121128. These numbers do not include the nearly $40 million proprietary colleges spent on lobbying from 2007 to 2012. *See* Tyler Kingkade, *For-Profit Colleges Spending Millions on Lobbying, Nearly $40 Million Since 2007*, HUFFINGTON POST (Aug. 30, 2012, 9:19 AM), http://www.huffingtonpost.com/2012/08/30/for-profit-colleges-lobbying_n_1842507.html.

164. *See* 34 C.F.R. §§ 668.6, 668.41 (2013). *See also* Auster, *supra* note 38, at 652–53.

average rate of employment within six months of the date of degree or certificate completion according to the same standards as listed above), such as by directing the viewer to the state accreditation agency's website.

Because the current disclosure requirements lack depth and uniformity,[165] this solution goes a step further while serving important governmental interests that will withstand judicial scrutiny: (1) disclosure serves an informational interest, (2) it reduces the appearance of corruption, and (3) it helps detect violations of law. Although mandatory disclosure legislation may not eradicate problems like the rising student loan default rate, it should give student-consumers—who, without this information, withdraw from school without receiving a degree or default on their loans[166]—the information they need to make informed decisions in the educational marketplace.

C. Adopt a Cause of Action with a Chance of Success for Students

The judiciary has heretofore relied on the academic abstention doctrine to stay out of the affairs of educational institutions.[167] The courts should acknowledge that, because the postsecondary education model has changed, it is necessary to vest proprietary schools with a fiduciary duty to their student-consumer. As the New Hampshire Supreme Court articulated,[168] this may be accomplished through the recognition of a limited fiduciary duty of good faith, fair dealing, and transparency to all current and potential students. Recognizing a general fiduciary duty serves four central purposes: (1) it places the judiciary back in step with modern reality of postsecondary education; (2) it abrogates the disfavored, paternalistic *in loco parentis* doctrine by treating student-consumers as adults capable of making informed decisions; (3) it places proprietary education institutions on clear notice of their duties to student-consumers; and (4) in the event that an institution breaches a fiduciary duty, it allows the plaintiff a more reasonable standard for bringing a claim against the institution in breach of its duty. Finally, recognizing the fiduciary duty acknowledges a special relationship where one has long existed unnoticed.

These recommendations are designed to encourage the right behavior of proprietary colleges and universities, in the form of relatively non-invasive regulation, and to enable student-consumers to make informed choices and have a fair shake at legal recourse if their choice was the result of fraud or deceit by a proprietary institution.

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165. *See* Program Integrity Issues, 75 Fed. Reg. 34,806, 34,835 (June 18, 2010); Program Integrity Issues, 75 Fed. Reg. 66,832, 66,833, 66,836 (Oct. 29, 2010). *See also* Auster, *supra* note 38, at 652–53.

166. *See* Hoxby & Turner, *supra* note 95.

167. *See* KAPLIN & LEE, *supra* note 79, at 104–05.

168. Schneider v. Plymouth State Coll. 744 A.2d 101 (N.H. 1999).

CONCLUSION

While many states still do not allow a plaintiff's tort or contract claims against a proprietary education institution to succeed, nearly every state provides some sort of avenue for fraud victims to seek legal redress and imposes fiduciary duties on many forms of business organizations.[169] Because the states are in the best position to regulate the institutions within their own borders, they should seize the opportunity to regulate an unbridled industry, before the damage—such as the historically high loan default rate—worsens.[170] While only ten percent of all students enrolled in postsecondary institutions attend proprietary colleges and universities, the student loan default rate among these students accounts for over forty percent of all federal student loans in default.[171] It is even more important that postsecondary education returns to an economy of reciprocal benefit and is not used as a means of fleecing consumers. As Justice Brandeis once said, "sunlight is said to be the best of disinfectants;"[172] it is time that the proprietary education industry is held to the same standards of accountability to which every other for-profit industry is held.

169. *See generally* Prentiss Cox, *Goliath Has the Slingshot: Public Benefit and Private Enforcement of Minnesota Consumer Protection Laws*, 33 WM. MITCHELL L. REV. 163 (2006).

170. Right or wrong, students attending proprietary schools assume more debt than their peers at traditional postsecondary schools. *See* Harkin, *supra* note 36, at 8–9. Therefore, it is imperative to find solutions to this problem sooner, not later.

171. *See* Harkin, *supra* note 36, at 11. *See also* Auster, *supra* note 38, at 667 n.244.

> The GAO reports that eighteen percent of for-profit graduates default on their Title IV loans. This figure only includes students who actually complete a degree. The default rate of students attending non-profit schools is almost a quarter of this default rate.

Id. (citations omitted).

172. Walter J. Enright, *What Publicity Can Do*, 58 HARPER'S WEEKLY 10 (1913), *available at* http://www.law.louisville.edu/library/collections/brandeis/node/196 (quoting Justice Brandeis).

A DOUBLE-EDGED SWORD: STUDENT LOAN DEBT PROVIDES ACCESS TO A LAW DEGREE BUT MAY ULTIMATELY DENY A BAR LICENSE

KAELA RAEDEL MUNSTER*

INTRODUCTION

"Misconception or not, lawyers are perceived as wealthy, well-to-do, educated professionals with the means to make their student loan payments."[1] This perception, however, may not be consistent with reality. Consider the following hypothetical: Lauren, a twenty-six-year old woman and recent law school graduate, pursued a legal education after achieving academic success in her undergraduate studies. In deciding whether to attend law school, Lauren relied on statistical reports that described recent graduates' employment and salary data, financial assistance, and ability to pursue a meaningful career upon graduation. Lauren decided to enroll at an American Bar Association ("ABA") accredited law school that offered her a substantial merit-based scholarship based on both her Law School

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1. Terri Harris, *Student Loan Default Could Result in License Revocation*, TENN. BAR ASS'N (Jul. 21, 2010, 2:38 A.M.), http://www.tba.org/journal/student-loan-default-could-result-in-license-revocation.

Admission Test ("LSAT") score, as well as her undergraduate academic record. Lauren's scholarship covered seventy-five percent of her tuition expenses, and yearly renewal of Lauren's scholarship was contingent upon her maintaining a minimum 3.0 grade point average. Lauren carried approximately $100,000 of prior academic indebtedness into law school so she relied on the assistance of her scholarship to fund her legal education. After Lauren's first year of law school, she was unable to maintain her scholarship so she subsequently had to take out private loans to offset her tuition and living expenses. Upon graduation from law school, Lauren's academic indebtedness totaled approximately $200,000 and remained at that amount when she sat for her state's Bar Examination. After she passed that exam, the State Bar refused Lauren's admission because the State Supreme Court had affirmed the State Bar Character & Fitness Committee's determination that, because of her high debt load and the fact that she had no reasonable plan for paying off her student loan debt, Lauren was financially irresponsible. After following in the path of countless young professionals who accrue academic debt in the hope of deferred success, Lauren was left destitute and found unfit to practice law.

The Character and Fitness assessment has been criticized by bar applicants, bar members, and scholars because of its arbitrary and unpredictable admission standards.[2] Like many aspects of the legal profession, the Character and Fitness assessment has not evolved to reflect current economic and social trends, as student loans are an integral and pervasive tool for many to attend law school.[3] Thus, basing the determination of an applicant's character and fitness on the concept of financial irresponsibility is an antiquated approach; the process must evolve to accurately reflect the current legal market.[4]

Due to the increasing costs and grim financial prospects associated with the pursuit of a law degree, reform is necessary in each state's perception of student debt as a factor in a Character and Fitness assessment, specifically the applicant's financial irresponsibility determination.[5] Since the 1980s, law school tuition has risen dramatically; from 1983 to 2008, for example, law school tuition rose at least two times faster than the inflation rate.[6] Between 2001 and 2013, the number of established law schools in the

2. Deborah L. Rhode, *Moral Character as a Professional Credential*, 94 YALE L.J. 491, 512–46 (1985).

3. *See infra* Part I.A.1–3.

4. *See infra* Part IV.B.

5. *Id.*

6. Maimon Schwarzschild, *The Ethics and Economics of American Legal Education Today*, 17 J. CONTEMP. LEGAL ISSUES 3, 5 (2008). *See also* AM. BAR ASS'N COMM'N ON LOAN REPAYMENT AND FORGIVENESS, LIFTING THE BURDEN: LAW STUDENT DEBT AS A BARRIER TO PUBLIC SERVICE 16 (2003), *available at* http://www.americanbar.org/content/dam/aba/migrated/legalservices/downloads/lrap/lrapfinalrepor

United States rose by nine percent.[7] Moreover, in 2012, average tuition at private law schools was $40,585 and the average in-state tuition for public law schools was $23,590.[8] This rise in price means that as of early 2013, the average law school graduate could expect to graduate with debt near or exceeding $100,000, not including any debt that he or she accumulated as an undergraduate student.[9] Lauren's story is not the exception—it is the frightening reality; many law students and law graduates may ultimately find themselves in a similar financial situation. The ABA recognizes that attending law school can be a financial burden for law students who fail to carefully consider "the financial implications of their decisions."[10]

Part I of this Article evaluates the bar admissions process, with a specific focus on the Character and Fitness assessment and the considerations that are taken into account by a Character and Fitness Committee before it issues a finding of financial irresponsibility. Part II discusses the Loan Repayment Assistance Programs ("LRAPs") that are in place at the state and federal, and which are also offered by many law schools. It argues that these programs are insufficient to address the large amounts of debt that law students can accumulate during the pursuit of a law degree. Part III further explores whether a legal education is a wise investment based on the abundance of misreported and misunderstood salary and employment statistics supplied by some law schools, student debt concerns, and the various tactics employed by some law schools to encourage prospective law students to obtain a law degree. Part IV analyzes the class action suits that law schools have faced because of the alleged misrepresentation in employment and salary data for former and current law students. Finally, Part V considers possible reforms that bar admissions boards should adopt to treat student loan debt separately from a determination of financial irresponsibility that adapts to meet the demands of twenty-first century lawyers.

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t.authcheckdam.pdf.

7. Anna Stolley Persky, *Law School? Bag it, Bloggers Say*, A.B.A. J. (Feb. 1, 2011), http://www.abajournal.com/magazine/article/law_school_bag_it_bloggers_say/2011.

8. Debra Cassens Weiss, *Tuition and Fees at Private Law Schools Break the $40K Mark, on Average*, A.B.A. J. (Aug. 20, 2012, 4:30 AM), http://www.abajournal.com/news/article/average_tuition_at_private_law_schools_breaks_40k_mark/; AM. BAR ASS'N COMM'N ON THE IMPACT OF THE ECON. CRISES ON THE PROFESSION AND LEGAL NEEDS, THE VALUE PROPOSITION OF ATTENDING LAW SCHOOL (2009), *available at* http://www. americanbar.org/content/dam/aba/migrated/lsd/legaled/value.authcheckdam.pdf [hereinafter THE VALUE PROPOSITION OF ATTENDING LAW SCHOOL].

9. *See* Schwarzschild, *supra* note 6, at 6.

10. THE VALUE PROPOSITION OF ATTENDING LAW SCHOOL, *supra* note 8. The ABA has stated, "[a] proper understanding of the economic cost of a legal education is vital for making an educated decision." *Id.*

I. THE ECONOMIC ENVIRONMENT OF THE LEGAL EDUCATION

While many factors may influence a person's decision to attend law school, a proper understanding of the economic costs of a legal education is necessary to making a well-informed decision.[11] The direct and opportunity costs associated with attending law school should be considered contemporaneously with the possibility of obtaining remunerative law-related employment after graduation.[12]

A. Is a Law Degree Really Worth Pursuing?

The value of an education, specifically the dream of attending a college or university and potentially pursuing a graduate degree, has been ingrained into the visionary future of many members of society.[13] Realization of this dream is predicated on the notion that "four years of higher education will translate into a better job, higher earnings, and a happier life."[14] In support of this belief, the College Board has stated that the difference in lifetime earnings between college or university graduates and high-school graduates is approximately $800,000.[15] This figure is highly controversial as there are many factors that determine the lifetime earnings gap.[16]

This belief can also be applied to the decision to pursue a legal education and is readily applicable in the law school context.[17] Professors Michael

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11. *Id.*

12. *Id.*

13. This includes children, parents, and educators alike. *See* Jacques Steinberg, *Plan B: Skip College*, N.Y. TIMES, May 15, 2010, at WK1.

14. *Id.*

15. Mary Pilon, *What's a Degree Really Worth?*, WALL ST. J. (Feb. 2, 2010, 12:01 AM), http://online.wsj.com/article/SB10001424052748703822404575019082819966538.html. "College Board is a not-for-profit membership association whose mission is to connect students to college success and opportunity." COLL. BD. ADVOCACY & POLICY CTR., TRENDS IN STUDENT AID 2010, at 2 (2010), *available at* http://trends.collegeboard.org/sites/default/files /SA _2010.pdf [hereinafter TRENDS IN STUDENT AID] ("The College Board & Advocacy Center was established to help transform education in America.").

16. Pilon, *supra* note 15. For example, there are a variety of factors that would likely increase or decrease the difference in lifetime earnings between the two graduates, such as the type of degree earned, the institution the degree is earned from, and the opportunity costs of attending a college or university, as well as the student loan debt accumulated from attending that school. *Id*. *See also* Kevin Carey, *That Old College Lie*, DEMOCRACY J. (Winter 2010), *available at* http://www.democracyjournal.org/pdf/15/Carey.pdf.; Kate Zernike, *Making College 'Relevant*,*'* N.Y. TIMES, Jan. 3, 2010, at ED16. These factors may have an astounding effect on one's determination to attend college based on the gap in lifetime earnings between college and high-school graduates. *Id.*

17. Charlotte Allen, *Overselling Law School*, MINDING THE CAMPUS (Feb. 2, 2009), http://www.mindingthecampus.com/forum/2009/02/here_at_minding_the_campus.html.

Simkovic and Frank McIntyre released a study in April 2013 that used economics and statistics to evaluate whether or not a law degree is worth pursuing.[18] The study focused on the difference in annual earnings and hourly wages between undergraduates and law graduates and accounted for unemployment and disability risk for both.[19] The study's ultimate determination was that a law degree is still worth pursuing despite dismal job prospects because a law graduate's earning over one's lifetime is much higher than the earnings of a person with solely an undergraduate degree.[20] However, the major flaw with this study is that the study considers only the expense involved in attaining a law degree; it does not address the fact that many law students have already incurred debt while pursuing an undergraduate education.[21] Furthermore, the ABA recognizes that "[f]ar too many law students expect that earning a law degree will solve their financial problems for life. In reality, however, attending law school can become a financial burden for law students who fail to carefully consider the financial implications of their decision."[22]

1. The Rising Costs of Law School Tuition

The economic downturn of 2007 through 2010 coincided with and contributed to tuition increases at some public and private law schools.[23] This tuition increase can be attributed to "[e]ndowment losses, declining state support, and difficulties in fundraising," causing numerous public law schools to raise tuition between ten percent and twenty-five percent per year during these three years.[24] Another reason tuition has increased is because of the addition of career services personnel and academic support services.[25]

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18. Michael Simkovic & Frank McIntyre, *The Economic Value of a Law Degree* (Apr. 13, 2013) (unpublished article with accompanying PowerPoint presentation), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 2250585.

19. *Id.*

20. *Id.*

21. *Id.*

22. THE VALUE PROPOSITION OF ATTENDING LAW SCHOOL, *supra* note 8.

23. The increase in private law school tuition costs amounts to a sixty percent increase in eight years. The average tuition at a private law school in 2000 was $21,790, while the average tuition at a private law school in 2008 was $34,298. John A. Sebert, *The Cost and Financing of Legal Education*, 52 J. LEGAL EDUC. 19 (2002). *See also* THE VALUE PROPOSITION OF ATTENDING LAW SCHOOL, *supra* note 8. This does not take into account an eighty-six percent increase in tuition costs from 1990 to 2000. Sebert, *supra*. From 1990 to 2000, tuition at state law schools increased for residents by 141%, and for nonresidents by 113%. *Id.* From 2000 to 2008, in-state tuition increased by 116%. The average state resident's tuition was $7,790 in 2000. *Id.* The average resident's tuition in 2008 was $16,836. THE VALUE PROPOSITION OF ATTENDING LAW SCHOOL, *supra* note 8.

24. THE VALUE PROPOSITION OF ATTENDING LAW SCHOOL, *supra* note 8.

25. *Id.* Moreover, the increasingly sophisticated technological systems

Additionally, law schools rely on their reputations and rankings to attract prospective law students to apply and to enroll at the schools.[26] Elite reputations are expensive, especially considering that the law school rankings by *U.S. News & World Report* take into account the "expenditures per student for instruction, library, and supporting student services," and the "expenditures per student for financial aid, indirect costs, and overhead."[27] The irony is that "[i]f an innovative college found a way to become more efficient and charge less while maintaining academic quality, its *U.S. News* [*& World Report*] ranking would actually go down."[28] In a counterintuitive reality, law schools have little to no short-run economic reason to decrease or attempt to control tuition but actually have a short-run economic incentive to increase yearly tuition.[29]

2. The "Bait & Switch"—Merit-Based Scholarship Tactics

One way for law schools to move up in the rankings is to attract highly qualified candidates by offering merit-based scholarships. The availability of merit-based scholarships drastically increased between 2005 and 2010.[30] Accordingly, some students have argued that some law schools offering these significant merit-based scholarships are using a tactic known as "bait and switch," to get top students in the door to improve the school's rankings in *U.S. News & World Report.*[31] The term "bait and switch" means that the schools in question extend a large number of scholarships to entering first year students, knowing that because of the rigid grading curve, a portion of these students will be unable to maintain the grade point average required to keep the scholarships.[32]

The *New York Times* spotlighted the issue of "bait and switch" scholarship tactics in an April 2011 exposé about Golden Gate School of

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incorporated into a law school's education, such as research providers, new technology for use in the classroom, and the support staff needed to operate these technological advancements all increase operating costs at law schools, which must be passed on to the students through an increase in tuition. *Id.*

26. *Id.*

27. Stephen P. Klein & Laura Hamilton, *The Validity of the U.S. News and World Report Ranking of ABA Law Schools*, ASS'N OF AM. L. SCH. (Feb. 18, 1998), http://www.aals.org/reports/validity.html.

28. Carey, *supra* note 16.

29. *Id.* However, law schools may attempt to control tuition costs to ensure that the school remains an attractive option for future law students who will pursue law degrees. *See* discussion *infra* Part I.D.

30. Bruce Buckley, *A Scholarship Bait and Switch?*, NAT'L JURIST, Sept. 2011, at 15.

31. *Id.* Namely, the amount of merit-based scholarships has increased by eighty percent since 2005, and law schools were able to extend more than $522 million in scholarship aid in 2010. *Id.*

32. *Id.*

Law.[33] In the article, a student received a merit-based scholarship to Golden Gate and presumed that maintaining the requisite 3.0 grade point average would be possible, if not likely, given her academic achievements and reassurances from admissions officials.[34] However, the fulfillment of this presumption proved to be problematic as the number of students on scholarship, fifty-seven percent of Golden Gate's first-year students, exceeded the generosity of the curve for all first-year law students.[35]

Law schools have a short-run, economic incentive to offer "bait and switch" scholarships because law schools are ranked based, in part, on the incoming year's LSAT scores and undergraduate grade point averages.[36] Merit-based scholarships target students who are likely to increase the school's entering student statistics.[37] Additionally, scholarships offered in the first year make it likely that the students who do not maintain the scholarship criteria will acquire student loans for the final two years to finance the remainder of their education.[38] For that reason, merit-based scholarship practice can function as a "discount" to lure the student to enroll at the institution.[39] The irony, however, is that the "discount" afforded to students receiving merit-based scholarship is usually funded at the expense of full-tuition students admitted to the school.[40] This "bait and switch" scholarship tactic has given some law students a false sense of

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33. David Segal, *Law Students Lose the Grant Game as Schools Win*, N.Y. TIMES, Apr. 30, 2011, at BU1.

34. *Id.*

35. *Id.* The first-year curve mandates that twenty five percent of a class can receive A's, and thirty-five percent of a class can receive a B- or above. *Id.* In order to maintain a 3.0 grade point average, the student must maintain at least a solid B average. Based on the curve, sixty percent of the class can receive above a B-; however, a B- will not meet the scholarship retention criteria. *Id.* Thus, in order to maintain a scholarship with a 3.0 retention criteria, the student must score in the top fifty percent of his or her classes, if not higher depending on the professor's discretion in the curve's distribution. *Id. See also, e.g.*, AM. BAR ASS'N SECTION OF LEGAL EDUC. AND ADMISSIONS TO THE BAR, STANDARDS AND RULES OF PROCEDURE FOR APPROVAL OF LAW SCHOOLS 2011–2012 (2011), *available at* http://www.americanbar.org/content/dam/aba/publications/misc/legal_education/Standards/standardsarchive/2011_2012_standards_and_rules_complete_book.authcheckdam.pdf.

36. Segal, *supra* note 33. Many people affiliated with law schools take the *U.S. News & World Report* rankings very seriously. *See* Gregory S. Crespi, *Comparing United States and New Zealand Legal Education: Are U.S. Law Schools Too Good?*, 30 VAND. J. TRANSNAT'L L. 31, 38 (1997). This can be attributed to the "influence of such rankings upon prospective applicants." *Id.* "The strong correlation between the range of subsequent social and professional opportunities for law school graduates and the generally perceived status of their school is so clear as to be beyond reasonable doubt." *Id.*

37. Segal, *supra* note 33.

38. *Id.*

39. *Id.*

40. William D. Henderson & Andrew P. Morriss, *How the Rankings Arms Race has Undercut Morality*, NAT'L JURIST, Mar. 2011, at 8.

affordability in acquiring a legal education and has enticed some students to enroll in a costly education under the impression that their scholarships would be easily maintainable.[41]

3. Average Student Indebtedness

Each year nearly 50,000 people begin their pursuit of a legal education.[42] However, "[o]ver the last twenty-five years, law school tuition has consistently risen two times as fast as inflation."[43] Additionally, it has been estimated that approximately eighty percent of law students obtain some form of student loans to pay for law school.[44] Financial aid distributed to undergraduate and graduate students in 2009 and 2010 amounted to $199.2 billion,[45] and the total amount of outstanding student debt exceeded $1 trillion by late 2012.[46]

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41. Debra Cassens Weiss, *Bait and Switch? Law Schools Gain in US News with Merit Scholarships Conditioned on High Grades*, A.B.A. J. (May 2, 2011, 6:34 AM), http://www.abajournal.com/news/article/bait_and_switch_law_schools_gain_in_us_news_with_merit_scholarships_conditi/. Students contemplating a law school that offers scholarships should research the median grade point average for current students enrolled at the institution and the number of scholarships offered to entering first-year students. *Id.* Moreover, the student should consider and be prepared for the possibility that the scholarship will not be maintained and determine the potential financial burden of obtaining a legal education. *Id.* In support of this concept, the Law School Transparency Project has submitted a proposal to the ABA Section of Legal Education to require law schools to publish both the scholarship retention data as well as the number of scholarships offered to entering first-year students. *Id.* The Transparency Project is an organization that advocates for clearer and accurate employment and salary data. *Id.*

42. Kyle P. McEntee & Patrick J. Lynch, *A Way Forward: Transparency at American Law Schools*, 32 PACE L. REV. 1, 5 (2012). *See also* Jennifer Liberto, *Obama to Offer Help for Students Buried in Debt*, CNNMONEY (Oct. 25, 2011, 6:32 PM), http://money.cnn.com/2011/10/25/news/economy/Obama_student_loan/index.htm (marking the highest unemployment rate since 1985 when the Labor Department began keeping records).

43. THE VALUE PROPOSITION OF ATTENDING LAW SCHOOL, *supra* note 8.

44. Margaret Miceli, *Law School & Student Loans*, EHOW, http://www.ehow.com/about_6552941_law-school-student-loans.html (last visited Feb. 10, 2014). *See also* Brendalyn Burrell Jones, Comment, *Bar Applicants: Are Their Lives Open Books?*, 21 J. OF THE LEGAL PROF. 153 (1996). *See generally Financial Aid: An Overview*, LSAC, http://www.lsac.org/jd/financing-law-school/financial-aid-overview (last visited Feb. 10, 2014).

45. TRENDS IN STUDENT AID 2010, *supra* note 15, at 3.

46. Jean Chatzky, *Student Loan Debt Reached $100 Billion Mark for First Time in History; Tips to Effectively Pay*, NYDAILYNEWS.COM (Oct. 26, 2011), http://www.nydailynews.com/news/local/student-loan-debt-reached-100-billion-mark-time-history-tips-effectively-pay-article-1.968364. By minimizing the quality of life while in school, students can accrue substantially less debt. President Barack Obama recently addressed the importance of concerns about student loan debt. On October 25, 2011, President Obama announced two measures that the Department of Education began offering in January 2012 to attempt to alleviate the burden of student loan debt. *See*

In 2011, the average public law student borrowed $68,827 for law school, and the average private law student borrowed $106,249.[47] Thus, many law students may acquire far more than $100,000 in loans in pursuit of a law degree, not including any student loan debt carried over from their undergraduate or other graduate institutions.[48] Not surprisingly, the ABA reports an average of $75,700 of aggregate debt (from both law school and undergraduate studies) for graduates from public law schools and approximately $125,000 of debt for graduates from private law schools.[49]

A study conducted by The Ohio State University may partially explain why students are willing to take on such large amounts of educational debt. Ironically, this study found a positive correlation between high debt levels and young adults' self-esteem and sense of mastery.[50] The study determined that in young adults aged eighteen to twenty-seven, the higher the amount of credit card and student loan debt, the higher the young adults' self-esteem because the young adults felt more in control of their lives.[51] Unfortunately, the same cannot be said for individuals aged twenty-eight to thirty-four. The study found that this age group began to show signs of stress because of student loan and credit card debt.[52] Researchers concluded that that debtors aged twenty-eight and older realized that they had overestimated their earning potential and that the debts are not as easy

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Liberto, *supra* note 42. The first measure "push[es] up the start date for more favorable terms on a special loan repayment program based on income." *Id. See also* Press Release, The White House Office of the Press Sec'y, FACT SHEET: Help Americans Manage Student Loan Debt (Oct. 25, 2011), *available at* http://www.whitehouse.gov/the-press-office/2011/10/25/fact-sheet-help-americans-manage-student-loan-debt. The second measure offers consolidation for graduates who have two or more types of federal loans, which would yield a small break from interest rates. Liberto, *supra* note 42. *See also* Press Release, The White House Office of the Press Sec'y, We Can't Wait: Obama Administration to Lower Student Loan Payments for Millions of Borrowers (Oct. 25, 2011), *available at* http://www.whitehouse.gov/the-press-office/2011/10/25/we-cant-wait-obama-administration-lower-student-loan-payments-millions-b.

47. Debra Cassens Weiss, *Average Annual Law School Loan Jumped 50 Percent Since 2001*, A.B.A. J. (May 9, 2011 8:32 AM), http://www.abajournal.com/news/article/average_annual_law_school_loan_jumped_50_percent_since_2001.

48. *Id.*

49. Debra Cassens Weiss, *Average Debt of Private Law School Grads is $125K; It's Highest at These Five Schools*, A.B.A. J. (Mar 28, 2012 4:29 AM), http://www.abajournal.com/news/article/average_debt_load_of_private_law_grads_is_125k_these_five_schools_lead_to_m.

50. Rachel Dwyer, *What, Me Worry? Young Adults Get Self-Esteem Boost from Debt*, OHIO ST. RES. NEWS (Jun. 6, 2011), http://researchnews.osu.edu/archive/youngdebt.htm. "Sense of mastery" means that the debtors believed that they were in control of their lives, and that they had the ability to achieve their respective goals. *Id.*

51. *Id.* The young adults viewed debt in mostly positive terms, rather than as a potential burden. *Id.*

52. *Id.*

to pay off as originally hoped and planned.[53]

There are two competing views generally invoked when discussing student loans and debt. First, some people believe that debt should be viewed positively because debt helps people invest in their future lives and careers.[54] The second view states that debt should be viewed negatively across all age classes because debt enables people to spend more money than they currently make.[55] Accumulating large amounts of debt can limit legal career choices, prevent employment in the public service sector of the legal market, and delay homeownership or marriage.[56]

A. Employment and Salary Trends

Many prospective and current law students are aware of the expenses associated with obtaining a legal education; however, many of these prospective and current law students may have been unaware that these costs may exceed the expected return on investment in the legal job market.[57] To make matters worse, law school tuition increased 267% from 1990 to 2002 and has continued to increase since then.[58] Additionally, since 2007, law school tuition has increased more than the pay elevations at firms of all sizes across the nation.[59] Thus, while law school costs have increased rapidly, law firm associate compensation has not.[60] This statistic means that

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53. *Id.*

54. *Id.*

55. *Id.*

56. THE VALUE PROPOSITION OF ATTENDING LAW SCHOOL, *supra* note 8. On the other hand, the lack of financial return does not mean that a legal career is not worth pursuing. *Id.* Some lawyers "receive intrinsic benefits from a satisfying career that cannot easily be quantified." *Id.*

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.* According to a Northwestern University Law study, approximately 15,000 attorney and legal-staff jobs at large law firms were terminated between 2008 and 2009. David Segal, *Is Law School a Losing Game?*, N.Y. TIMES, Jan. 8, 2011, at BU1. The large-firm associates' starting salaries ranged between $130,000 and $160,000, and many current and prospective law graduates expect to be able to earn a comparable salary. THE VALUE PROPOSITION OF ATTENDING LAW SCHOOL, *supra* note 8. This notion is called the bimodal salary curve and is quite unrealistic. *See, e.g.*, *Salary Distribution Curve*, NALP, http://www.nalp.org/salarydistrib (last visited Feb. 6, 2014). In 2008, only twenty-three percent of the 2008 graduates started with a large-firm associate salary, and most of the graduates, approximately forty-two percent, began their legal careers with an annual salary of less than $65,000. Weiss, *supra* note 8. The bimodal salary curve has two curves, a higher one and a lower one with clusters around certain monetary values that indicate the type of legal position attained based on the placement on the curve. *See, e.g.*, INSTAPUNDIT.COM (July 25, 2010), http://pjmedia.com/instapundit/103584/. For instance, those individuals clustered in the higher salary grouping are likely to be those that have accepted positions at large law firms. *Id.*

newly-minted lawyers are carrying much greater debt amounts upon graduation than their predecessors did.[61]

Once they are fully employed after graduation, most newly minted lawyers need to make at least $65,000 in order to meet their basic needs.[62] Taking that into consideration, a graduate who has student loan debt of $100,000 would need to make $78,000 annually to repay the loan without enduring financial hardship, or he or she must earn $52,000 annually to repay the debt with some financial difficulty.[63] The reality is that, due to the combination of rising costs of a legal education and a bleak job market, attending law school may not be financially possible, or reasonable, for many prospective law students.[64]

There are many ways to minimize the amount of money that any one law student borrows. First, some lawyers have recommended that students defer entering law school for a few years after graduating from college so that they can work to pay for the undergraduate degree that they earned.[65] Another suggestion is for a student to attend law school on a part-time basis, allowing the student to work and attend law school simultaneously.[66] Alternatively, some law schools have imposed mandatory financial aid conferences on first-year and third-year law students and have regularly offered debt classes or seminars with financial professionals, like bankers or financial planners.[67] Additionally, some have recommended that all law students pay off consumer debt before entering their first year of law school.[68] While all of these suggestions would aid in limiting the borrower's need, they may not be feasible for many individuals.

B. Bankruptcy and Student Loans

Currently, the United States Bankruptcy Code states that student debt

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61. *Id.*

62. The $65,000 figure marks an important threshold: Many analysts argue that new lawyers must earn a salary of at least $65,000 to afford the monthly student loan payments accumulated during law school and, possibly, from undergraduate studies as well. Jeffrey Mictabor, *Law School Graduates Awash in Student Loan Debt*, EZINE ARTICLES (Feb. 3, 2011), http://ezinearticles.com/?Law-School-Graduates-Awash-in-Student-Loan-Debt&id=5815216.

63. Kyle P. McEntee & Patrick J. Lynch, *A Way Forward: Improving Transparency in Employment Reporting at American Law Schools*, 32 PACE L. REV. 1, 4 at n.10 (2012). The obvious discrepancy between the $65,000 figure and the $52,000 figure is that most graduating law students have accumulated student loan debt in excess of $100,000. *Id.*

64. Weiss, *supra* note 8. *See also* Sebert, *supra* note 23.

65. Rebecca Larsen, *How To Manage Your Debt*, NAT'L JURIST, Mar. 2011, at 18.

66. *Id.*

67. *Id.* at 19. For instance, Case Western Reserve University School of Law has implemented this idea. *Id.*

68. *Id.*

cannot be discharged in bankruptcy proceedings unless the student can prove undue hardship,[69] which is highly improbable and extremely difficult.[70] The difficulty in establishing undue hardship is that the debtor must not only demonstrate a current inability to fulfill the debtor's financial commitment but must also show that, in all likelihood, the debtor will be unable to pay the financial commitment in the future.[71]

Further complicating the task of discharging student debt in bankruptcy proceedings is the recommendation, made by the Commission on the Bankruptcy Laws of the United States, that to determine whether student loans may be discharged in bankruptcy, the debtor must satisfy a tripartite test.[72] The first element requires the debtor to show that he or she would be unable to maintain a minimal standard of living, based on his or her current income and expenses, if required to repay the loans.[73] Second, the debtor must prove that additional circumstances exist proving that the debtor's current financial position is likely to remain as it is for a significant portion of the student loan repayment period.[74] Lastly, the debtor must prove that he or she has made good-faith efforts to repay the student loan debt.[75]

Under these requirements a student loan borrower faces a nearly impossible battle to discharge his or her debts. In 2008, there were 72,000 federal student loan borrowers who filed for bankruptcy.[76] Of those, only twenty-nine of the 72,000 borrowers were able to get part or all of the debt discharged in bankruptcy proceedings by proving undue hardship.[77]

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69. 11 U.S.C. § 523(a)(8) (2012).

70. Rafael I. Pardo, *The Real Student-Loan Scandal: Undue Hardship Discharge Litigation*, 83 AM. BANKR. L.J. 179, 184 (2009). *See also* Jennifer L. Frattini, *The Dischargeability of Student Loans: An Undue Burden?*, 17 BANKR. DEV. J. 537 (2001).

71. *See* Goulet v. Educ. Credit Mgmt. Corp., 284 F.3d 773 (7th Cir. 2002); *In re* Frech, 62 B.R. 235 (Bankr. D. Minn. 1986).

72. Andrew M. Campbell, Annotation, *Bankruptcy Discharge of Student Loan on Ground of Undue Hardship Under Sec. 523(a)(8)(B) of Bankruptcy Code of 1978 (11 U.S.C.A. § 523(a)(8)(B)) Discharge of Student Loans*, 144 A.L.R. Fed. 1, 30 (1998) (citing the three-part test enunciated in Brunner v. N.Y. State Higher Educ. Servs. Corp., 831 F.2d 395 (2d Cir. 1987)). Courts approach this test very conservatively, and place the burden of proof upon the debtor. James L. Fly & Michael Sjuggerud, *Student Loans in Bankruptcy: Policy Analysis and Portfolio Risk for Lenders*, 123 BANKING L.J. 530, 553 (2006). If all three parts of the test are not satisfied, then the debtor has not established an undue hardship posed by repayment of the student loans, and accordingly, the loans will not be dischargeable. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. AnnaMaria Andriotis, *Things Student Loan Companies Won't Say*, WALL ST. J. SMARTMONEY (Sept. 27, 2011), http://finance.yahoo.com/loans/article/113573/things-student-laon-companies-wont-say-smartmoney.

77. *Id.*

C. Financial Incentives of the *U.S. News & World Report* Rankings and the Accreditation Process

Law school rankings are extremely important; people in the legal profession and those seeking to become lawyers utilize these rankings in assessing the caliber of law schools.[78] *U.S. News & World Report* ranks law schools on a variety of factors, and these rankings receive considerable attention that may affect important decisions.[79] For instance, students may use these rankings in selecting which schools to attend, while hiring departments may use them in their hiring process.[80] These rankings are calculated using twelve measures of quality.[81] One measure of quality that incentivizes law schools to increase tuition is called "expenditures per student."[82] This measure includes the yearly increase in the cost of tuition and thus, law schools are ranked, in part, based on the yearly increase of tuition.[83] This measure of quality incentivizes law schools to increase tuition, regardless of the school's need.[84]

The ABA continued to accredit new schools almost every year during the past decade, and as of 2013, there were over two hundred accredited law schools.[85] Between 2000 and 2013, sixteen law schools received full

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78. Stephen P. Klein & Laura Hamilton, *The Validity of the U.S. News and World Report Ranking of ABA Law Schools*, ASS'N OF AM. L. SCH. (Feb. 18, 1998), http://www.aals.org/reports/validity.html.

79. *Id.*

80. *Id.*

81. Robert Morse & Sam Flanigan, *Law School Rankings Methodology*, U.S. NEWS & WORLD REP. (Mar. 14, 2011), http://www.usnews.com/education/best-graduate-schools/articles/2011/03/14/law-school-rankings-methodology-2012?PageNr=2. These measures of quality include a peer assessment (25%), assessment scored by lawyers/judges (15%), selectivity (25%, which includes Median LSAT scores for 12.5%, Median Undergraduate GPA for 10%, and acceptance rate for 2.5%), placement success (20%, which includes the placement measured at graduation 4% and at nine-months from graduation for 16%), bar passage rate and faculty resources (15%, which includes expenditures per student for 11.25%, student/faculty ration for 3%, and library resources). *Id.*

82. *Id.*

83. For example, if a law school increases tuition by $1,000, it can subsequently increase expenditures on "instruction, library, and supporting student services" by $1,000 per student. *Id*. Thus, a school can improve its score under this metric by raising tuition.

84. *Id.* Additionally, the school has no short-run, economic incentive to help alleviate the financial plight of law student tuition, despite the dismal job market. *Id.*

85. *ABA-Approved Law Schools by Year, Section of Legal Education and Admissions to the Bar*, AM. BAR ASS'N, http://www.americanbar.org/groups/legal_education/resources/aba_approved_law_schools/by_year_approved.html (last visited Feb. 11, 2014) [hereinafter *ABA-Approved Law Schools by Year*]. Further, the Department of Education ("DOE") stipulates that the Council and the Accreditation Committee of the ABA Section of Legal Education and Admissions to the Bar is the accrediting agency. AM. BAR ASS'N SECTION OF LEGAL EDUCATION AND ADMISSIONS TO THE BAR, THE LAW SCHOOL ACCREDITATION PROCESS

accreditation, and four schools received provisional approval.[86] It has been argued that the ABA's continual approval of new law schools is a disservice to the profession.[87]

II. LOAN REPAYMENT ASSISTANCE PROGRAMS REMAIN INSUFFICIENT TO SUBSTANTIALLY REDUCE LAW STUDENT DEBT OBLIGATIONS

Law students who desire to pursue careers in public service may face particular difficulty paying their student loan debt because the salary for many public service jobs has not kept pace with the increase in education costs.[88] In response to these concerns, Loan Repayment Assistance Programs ("LRAPs") were created to "provide financial aid to law school graduates working in the public interest sector, government, or other low-paying legal fields."[89] To be eligible for most LRAP programs, a graduate must be employed by a public interest entity; for most LRAP participants, the benefits received from the program makes having a career in public interest law possible.[90] The main problem with LRAPs is that some of the programs may be insufficiently funded to meet the needs of the number of

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3 (Aug. 2013), http://www. americanbar.org/content/dam/aba/publications/misc/legal_education/2013_revised_accreditation_brochure_web.authcheckdam.pdf [hereinafter THE LAW SCHOOL ACCREDITATION PROCESS]. The ABA and the DOE require that each approved law school, provisionally approved law school, and law school not yet approved answer the ABA's annual questionnaire. McEntee & Lynch, *supra* note 42. The questionnaire inquires about facts relevant to compliance with accreditation standards and "elicits information and data regarding curriculum, faculty, facilities, fiscal and administrative capacity, technology resources, student profiles, administrative capacity, technology resources, student profiles, bar passage rates, and student placement data." THE LAW SCHOOL ACCREDITATION PROCESS, *supra*, at 8.

86. *ABA-Approved Law Schools by Year*, *supra* note 85.

87. Annie Lowrey, *When Law School Becomes a Bad Investment*, WASH. POST (October 30, 2010, 9:14 AM), http://www.washingtonpost.com/wp-dyn/content/article/2010/10/30/AR2010103004638.html. This is caused by the fact that between 2000 and 2013, the number of awarded law degrees increased by eleven and a half percent. *Id.* The supply of new lawyers vastly outweighs demand in the job market. *Id.* Consider, by contrast, the law school process to that of the medical school structure. *Id.* The medical school process has been known to have "higher start-up costs," and medical schools have not typically been known as "money-makers." *Id.* The limited number of accredited medical schools allows only a relatively small number of students to receive medical degrees, and the demand far outweighs the supply. *Id*. The complete opposite is experienced in the legal market, as supply far outweighs demand. *Id.*

88. Philip G. Schrag & Charles W. Pruett, *Coordinating Loan Repayment Assistance Programs with New Federal Legislation*, 60 J. LEGAL EDUC. 583, 583 (2011).

89. *Law School Loan Repayment Assistance Programs*, EQUAL JUST. WORKS (Apr. 19, 2011), http://www.equaljusticeworks.org/resources/student-debt-relief/law - school-loan-repayment-assistance-programs.

90. HEATHER WELLS JARVIS, FINANCING THE FUTURE: RESPONSES TO THE RISING DEBT OF LAW STUDENTS 5 (2006), *available at* http://www.equaljusticeworks.org/sites/default/files/financing-the-future2006.pdf.

graduates needing this assistance, a number that is consistently growing larger with the increasing costs of obtaining a law degree and the scarcity of law-related jobs elsewhere in the economy.[91]

A. Federal Loan Repayment Assistance Program Under the College Cost Reduction and Access Act

The problem of high monthly repayment obligations for law students' educational debts has been a growing concern; accordingly, Congress responded in 2007 by passing the College Cost Reduction and Access Act ("CCRAA").[92] "In two provisions of the CCRAA, Congress has significantly improved access to higher education . . . for persons who would like to have lower-paying public service careers but who will be saddled by high educational debts incurred to obtain the education that they need to serve the public."[93] These two provisions created a system of "income-based repayment" and established the federal Public Service Loan Forgiveness Program.[94]

1. Income-Based Repayment—Applies to all Low-Income Earning Undergraduates and Graduates

In light of the economic conditions that prevailed in 2007, Congress expanded the LRAPs to offer all graduates a form of assistance in repaying student loan debt by creating a program of "income-based repayment" ("IBR").[95] This program does not condition participation on whether the borrower works in public service; rather, eligibility depends "on the source of the loan, the amount of the debt, and the borrower's income."[96] This program applies to graduates with federally-guaranteed or federally-extended loans and applies a formula to determine each person's payment.[97] The formula applied to attain the required monthly payment

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91. Schrag & Pruett, *supra* note 88, at 583. Additionally, "the recession that began in 2008 caused private sector firms to reduce their hiring, prompting more student interest in public sector employment." *Id.* Additionally, forgiveness of a debt will typically give rise to income under the Internal Revenue Code. *See* I.R.C. § 61(a)(12) (2012). However, forgiveness under LRAP is tax-free according to IRS Revenue Ruling 2008-34. *See* Rev. Rul. 2008-34, 2008-28 I.R.B. 76.

92. Philip G. Schrag, *Federal Student Loan Repayment Assistance for Public Interest Lawyers and Other Employees of Governments and Nonprofit Organizations*, 36 HOFSTRA L. REV. 27, 35 (2007).

93. *Id.* at 28.

94. Schrag & Pruett, *supra* note 88, at 590.

95. *Compare* College Cost Reduction and Access Act, Pub. L. No. 110-84, § 203, 121 Stat. 784 (2007) (listing eligibility requirements that do not include public service), *with* Higher Education Opportunity Act, Pub. L. No. 110-315, § 451(b)(1), 122 Stat. 3262 (2008) (defining a public service job requirement).

96. Schrag & Pruett, *supra* note 88, at 592.

97. *Id.* at 590–91.

equals fifteen percent of the borrower's discretionary income broken into twelve equal, monthly payments.[98] The amount typically determined by this formula yields an obligation of approximately ten percent of one's adjusted gross income.[99] If the borrower's income rises,

> [T]he monthly repayment obligation increases as well, but it will never exceed more than about 10 percent of adjusted gross income. If it rises so much that the borrower would pay less per month under a ten-year repayment plan, the borrower will pay the ten-year payment amount until the loan is repaid or forgiven. IBR includes an element of loan forgiveness, in that if a borrower repays through the IBR plan for twenty-five years, any balance of principal or interest still owing at the end of that time is forgiven.[100]

This is particularly important for lawyers in the private sector and has offered huge relief for many graduates as it has made it possible for the graduates to make affordable monthly payments while affording life's basic necessities and to avoid the possibility of defaulting on their student loans.[101]

2. Public Service Loan Forgiveness Program—A Ten-Year Commitment to Work at a Public Service Organization Will Eliminate One's Student Debt

For graduates entering the public interest sector, the CCRAA provides an alternative to the IBR program that offers more benefits than the IBR program (though these public service workers are eligible for either program).[102] The Public Service Loan Forgiveness ("PSLF") Program allows the federal government to forgive an individual's remaining debt after ten years of public service.[103] The law defines public service work that is eligible under this LRAP very broadly and thus, "all [full-time][104] employment by any level of American government (federal, state, local, or tribal) qualifies, as does employment by any organization that is tax-exempt pursuant to Section 501(c)(3) of the Internal Revenue Code."[105]

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98. *Id.* The discretionary income is calculated based on "the borrower's adjusted gross income (AGI) minus [one-hundred and fifty] percent of the federal poverty level for a family that is the size of the borrower's family." *Id.* at 591. *See also* I.R.C. § 62 (2012) (defining adjusted gross income).

99. Schrag & Pruett, *supra* note 88, at 591.

100. *Id. See also* 20 U.S.C. § 1098e(b)(7) (2012) (directing Secretary to repay or cancel certain outstanding loans).

101. Schrag & Pruett, *supra* note 88, at 592.

102. *Id.*

103. *Id.*

104. 34 C.F.R. § 685.219(b)(1) (2013) (defining "full-time").

105. Schrag & Pruett, *supra* note 88, at 592. *See also* 20 U.S.C. §

The ten-year requirement for working in a public service organization does not need to be continuous, the law merely requires that 120 months of payments be made during the time the borrower was employed in a public service organization.[106]

3. Additional Loan Assistance Programs and the Limited Funds Currently Available

In 2008, Congress created three additional loan forgiveness programs for certain categories of public interest lawyers, such as prosecutors, public defenders, and civil legal aid lawyers.[107] The John R. Justice Prosecutors and Defenders Incentive Act of 2008 "authorized the U.S. Department of Justice to make funds available to repay the student loan debt of prosecutors and defenders who agree to serve in those capacities for at least three years."[108] The amount of funds available for this type of assistance under this law is up to $10,000 a year per person in loan forgiveness, with a maximum of lifetime forgiveness of $60,000.[109] Another program that Congress created was the Civil Legal Assistance Attorney Student Loan Repayment Program, which "authorizes the U.S. Department of Education to make forgiveness of up to $6,000 a year available to civil legal aid lawyers, with a lifetime maximum of $40,000."[110] For the 2010 fiscal year, Congress appropriated ten million dollars for the John R. Justice program and five million for the civil legal aid program; however, these funds were reduced to three and a half million dollars for both programs for the 2012 fiscal year.[111] The main problem with these programs is that, not only does Congress need to appropriate the money necessary for the loan assistance, but also, the number of lawyers that are applying for these funds may exceed the available appropriations.[112]

While the amount of assistance available under the LRAPs is certainly a great benefit to many graduates, it may not have a significant enough impact in the long-term. In some graduates' lives, even the minimum payments required by the loans is a financial hardship, in light of the low salaries and high living costs.

1087e(m)(3)(B)(i) (2012) (defining a public service job requirement).

106. *See* 20 U.S.C. § 1087e(m)(1)(A) (2012) (omitting any continuity requirement as a condition for public service employment).

107. Schrag & Pruett, *supra* note 88, at 595.

108. *Id. See also* 42 U.S.C. § 3797cc-21 (2012) (authorizing loan repayment for prosecutors and defenders).

109. Schrag & Pruett, *supra* note 88, at 595.

110. *Id*.

111. *Id.* at 595–96. *See also* BUREAU OF JUSTICE ASSISTANCE, U.S. DEP'T OF JUSTICE, 2012 JOHN R. JUSTICE STUDENT LOAN REPAYMENT GRANT STATE AWARD AMOUNTS (2012), *available at* https://www.bja.gov/Funding/12JRJAllocations.pdf.

112. Schrag & Pruett, *supra* note 88, at 596.

B. State Loan Repayment Assistance Programs

LRAPs are currently available in twenty-four states; out of these, eight have been created since 2000.[113] More states may soon enact similar legislation, as these programs are under consideration and development in at least seven additional states.[114] The LRAPs are usually "[c]reated and administered by bar associations, bar foundations, independent nonprofit organizations and state education administrations," as well as certain public and private law schools."[115]

These programs are typically funded by Interest On Lawyer's Trust Accounts ("IOLTA") funds[116] and from grants from other sponsoring organizations.[117] Similar to the federal LRAPs, almost all state LRAPs require recipients to be practicing law in "qualifying employment" within the state.[118] "Characteristics of state LRAPs vary, but definitions of 'qualifying employment' in all states include civil legal aid and in some states include public defense, prosecution, and other government and nonprofit legal organization work."[119]

C. Law School Loan Repayment Assistance Programs

As of 2012, approximately 100 public and private law schools offer LRAPs.[120] A law school graduate can apply for and receive funds from these school-based LRAPs to help with his or her student loan repayment.[121] Many schools receive the funding for LRAPs through large gifts from donors after the donors have been "educated about the debt burden faced by today's graduates and the impact this debt burden has." [122]

113. JARVIS, *supra* note 90, at 21; *State Loan Repayment Assistance Programs*, *Standing Committee on Legal Aid & Indigent Defendants*, AM. BAR ASS'N, http://www.americanbar.org/groups/legal_aid_indigent_defendants/initiatives/loan_repayment_assistance_programs/state_loan_repayment_assistance_programs.html (last visited Apr. 7, 2014) [hereinafter *State Loan Repayment Assistance Programs*].

114. *See* JARVIS, *supra* note 90, at 21.; *State Loan Repayment Assistance Programs*, *supra* note 113.

115. JARVIS, *supra* note 90, at 6–9, 21.

116. IOLTAs are accounts into which a state's bar association requires lawyers to place client fund money while awaiting its repayment or use towards the client's legal fees. These accounts accrue interest, and the interest is then used to establish these LRAPs. *Id.* at 21 & n.22.

117. *Id.* at 21. A nonprofit loan provider, The Student Loan Program, funds and administers Kentucky's LRAP using student loan interest and bonds. *Id.* Washington State's program is funded primarily by an affinity relationship with a loan consolidation vendor. *Id.*

118. *Id.*

119. *Id.*

120. *State Loan Repayment Assistance Programs*, *supra* note 113.

121. JARVIS, *supra* note 90, at 5.

122. *Id.* at 8.

Funding may also be made available through the school's operating budget.[123]

Ultimately, law school LRAPs help law schools improve society and the legal profession by making careers in public interest law possible as a financial matter. Due, however, to the limited number of law schools that offer LRAPs and the limited funds available to graduates through both state LRAPs and law school LRAPs, these programs are only a starting point to aiding graduates to pursue careers in public service.[124]

III. SUE 'EM ALL: SCRUTINIZING LAW SCHOOL EMPLOYMENT AND SALARY REPORTING

Between August 2011 and July 2013, fifteen class action suits were filed against law schools by former law students. The complaints alleged a variety of claims, all of which centered on the issue of inadequate employment and salary data proffered by the law schools during the recruitment process.[125] These class action suits served as tools for social change: at their core, they sought a systematic transformation of the manner in which law schools market themselves to prospective law students.[126] Along with damages, these suits sought disaggregated information in order to hold law schools accountable and to restore rationality to the pursuit of a legal education.[127]

In August 2011, the first three of the fifteen class action suits were filed on behalf of law school graduates who sued their former institutions for alleged distortions in employment and salary statistics.[128] By July of 2013,

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123. *Id.* at 9.

124. *Compare ABA-Approved Law Schools by Year*, *supra* note 85 (stating that there are over 200 accredited law schools), *with State Loan Repayment Assistance Programs*, *supra* note 113 (stating that approximately 100 law schools offer LRAPs).

125. *12 More Law Schools Facing Class Actions*, L. SCH. TRANSPARENCY (Feb. 1, 2012), http://www.lawschooltransparency.com/2012/02/breaking-12-more-law -schools-facing-class-actions/.

126. *Class Action Suits Filed Against Cooley and NYLS*, L. SCH. TRANSPARENCY (Aug. 10, 2011), http://www.lawschooltransparency.com/2011/08/breaking-class-action-suits-filed-against-cooley-and-nyls/.

127. *Id.*

128. The first suit, Alaburda v. Thomas Jefferson Sch. of Law ("TJSL"), was brought by a former graduate, Anna Alaburda, who alleged that TJSL conducted unfair business practices, committed intentional fraud, and negligently misrepresented the institution to its students. *See* Complaint, Alaburda v. Thomas Jefferson Sch. of Law, 2012 WL 6039151 (Cal. Super. Ct. Nov. 29, 2012) (No. 37-2011-00091898-CU-FR-CTL) (filed May 26, 2011) [hereinafter Thomas Jefferson Complaint]. The second and third suits were brought against New York Law School ("NYLS") and Thomas M. Cooley Law School ("Cooley"). *See* Complaint, Gomez-Jimenez v. N.Y. Law Sch., 943 N.Y.S.2d 834 (N.Y. Sup. Ct. Mar. 21, 2012) (No. 652226/11) (filed May 26, 2011 [hereinafter New York Law School Complaint]; Complaint, MacDonald v. Thomas M. Cooley Law Sch., 880 F.Supp.2d 785 (W.D. Mich. 2012) (No. No. 1:11CV00831)

two of these suits had been dismissed. In defending the court's decision to dismiss the suit against New York Law School ("NYLS"), the court stated, "not every ailment afflicting society may be redressed by a lawsuit."[129] Since then, however, twelve more law schools have faced lawsuits alleging similar complaints of fraud.[130] Some courts have disagreed with conclusion reached by the court in the case against NYLS and have permitted these suits to go forward, indicating that, despite the lack of initial success, such complaints may have staying power.[131]

A. Analyzing the Complaints

The complaints in most of the fifteen cases alleged that the law schools in question had reported misleading employment statistics—*e.g.*, by not disclosing "the number of graduates who found full-time, permanent jobs for which bar passage was required."[132] At the time at which defendant schools reported these statistics, the ABA permitted post-graduation jobs that did not require a law degree, part-time work, and non-permanent work

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(filed Aug. 10, 2011) [hereinafter Cooley Complaint]. The same law firm represented the two classes using a boilerplate complaint and alleging the same injury but utilizing different facts relevant to the stated institution in support of the claim. *Compare* New York Law School Complaint, *supra*, *with* Cooley Complaint, *supra*. *See also* Patrick G. Lee, *Law Grads Sue Over Tuition*, WALL ST. J. (Aug. 11, 2011, 10:18 AM), http://online.wsj.com/news/articles/SB10001424053111904823804576500694179259396; Sophia Pearson, *New York Law School Sued by Students Over Claims about Graduates' Success*, BLOOMBERG NEWS (Aug. 10, 2011, 11:24 AM), http://www.bloomberg.com/news/2011-08-10/new-york-law-school-sued-by-students-over-claims-about-graduates-success.html; Sarah Mui, *Grads Sue New York Law School and Cooley Law, Saying They Inflated Job and Salary Stats*, AM. BAR ASS'N (Aug. 10, 2011, 11:36 AM), http://www.abajournal.com/news/article/grads_sue_new_york_law_school_and_cooley_law_saying_they_inflated_job_and_s/.

129. Gomez-Jimenez v. N.Y. Law Sch., 943 N.Y.S. 2d 834, 854 (N.Y. Sup. Ct. 2012).

130. *12 More Law Schools Facing Class Actions*, *supra* note 125. In addition to the three original law suits, twelve more law schools were sued: Albany Law School, Brooklyn Law School, California Western School of Law, Chicago-Kent College of Law, DePaul University College of Law, Florida Coastal School of Law, Golden Gate University School of Law, Hofstra Law School, John Marshall School of Law, Southwestern Law School, University of San Francisco School of Law, and Widener University School of Law. *Id.* Editor's Note: At the time of publication, the lawsuits against Albany Law School, Brooklyn Law School, Chicago-Kent College of Law, DePaul University College of Law, and John Marshall School of Law had been dismissed.

131. *See* Harnish v. Widener Univ. Sch. of Law, 931 F. Supp. 2d 641, 651–652 (D.N.J. 2013) ("Here, an employment rate upwards of 90 percent plausibly gave false assurance to prospective students regarding their legal employment opportunities upon investment in and attainment of a Widener degree. While the thread of plausibility may be slight, it is still a thread. At this motion to dismiss stage . . . Plaintiffs have sufficiently pled an unlawful affirmative act under the NJCFA.").

132. *Id.*

to count towards a graduating class's employment statistics.[133] The complaints alleged that these employment reporting standards and statistics gave prospective law students a false sense of security that further encouraged prospective law students to buy-in to an "unwise investment decision."[134] However, before these complaints were filed, the ABA announced it would publish more information about employment and salary statistics in an attempt to avoid the reporting of skewed statistics that provide an unrealistic picture to prospective law students.[135] In June 2011, the ABA became aware of the reporting methods that had been used to portray an overly optimistic perspective on the financial benefits incident to attaining a legal education.[136] In January 2012, the ABA announced that it would promulgate a series of new regulations and impose severe penalties for law schools that misreport data.[137]

All fifteen of the law schools targeted by class action lawsuits brought by former students are ABA-accredited law schools that have been sued for inflating employment and salary statistics.[138] This phenomenon is significant because the lawsuits sought a remedy for two serious problems in the legal education system: first, the cost of obtaining a legal education; and second, the reality of the changing market for the services of newly minted lawyers. The plaintiffs in these lawsuits alleged that both problems were exacerbated by the way in which the law schools in question reported their graduates' employment statistics.[139] Unemployed law school graduates filed this type of suit because the legal economy was struggling and because there was a nationwide job crisis in the legal sector.[140] The

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133. Elizabeth Ewing, *Employment Transparency Battle Heats Up*, NAT'L JURIST, Sept. 2011, at 6, 8. *See infra* Part III.C. These statistics skew prospective law students' perception of post-graduate employment. *Id. See also* Scott Jaschik, New Scrutiny on Law School Data, INSIDE HIGHER ED. (Oct. 6, 2011), http://www.insidehighered.com/news/2011/10/06/plans_announced_to_sue_15_law_schools_over_placement_data.

134. Kyle McEntee & Patrick J. Lynch, *Do Law Schools Defraud Students?*, N.Y. POST (Oct. 11, 2011, 4:00 AM), http://nypost.com/2011/10/12/do-law-schools-defraud-students/.

135. Ewing, *supra* note 133, at 6, 8.

136. *See id.* at 8.

137. *Bar Admissions, Section of Legal Education and Admissions to the Bar*, AM. BAR ASS'N, http://www.americanbar.org/groups/legal_education/resources/bar_admissions.html (last visited Feb. 8, 2014); Tierney Plumb, *Consumer Data Will Be 'More Accurate, Timely and Complete*,' NAT'L JURIST, Jan. 2012, at 8. Additionally, the ABA has faced intense scrutiny because of its acknowledgement that some law schools reported inflated LSAT and GPA data. *Id.*

138. *See ABA-Approved Law Schools by Year*, *supra* note 85.

139. *See, e.g.*, NEW YORK LAW SCHOOL COMPLAINT, *supra* note 129, at 3.

140. McEntee & Lynch, *supra* note 134. *See also* LAW SCH. TRANSPARENCY, WINTER 2012 TRANSPARENCY INDEX REPORT (Jan. 2012), *available at* http://www.lawschooltransparency.com/documents/Winter2012/Winter_2012_Index_Report.pdf. This Report analyzes the class of 2010 employment information available

class actions alleged that the defendant law schools had provided information designed to "mislead, deceive, and prompt consumers" to attend law school with the overly optimistic expectation of achieving financial stability upon graduation.[141]

B. Potential Effects of the Complaints

Not surprisingly, the first three lawsuits alleged that the defendant law schools had published false employment and salary statistics.[142] These class action suits faced formidable challenges despite the obvious disconnect between the reality of the job market and the employment and salary data reported by the law schools.[143] Even the Dean of TJSL, Rudy Hasl, admitted in 2012 that "it is likely that more law schools will be sued over [their] employment numbers;" he added, however, that "only schools that tinkered with their numbers are at risk of losing such a suit."[144] At least one expert agreed with Dean Hasl, believing that it would be difficult for these plaintiffs to win in these cases.[145] Not only would a complainant have to prove that "there was reasonable reliance on [the] employment [and salary] statistics provided by the school when the student made the decision to attend law school," but he or she would also have to establish that the class as a whole shared the same reliance.[146] This litigation hurdle is very difficult to clear because this determination is individualized and would need to be examined on a case-by-case basis.[147]

Moreover, the proof required to prevail in this type of a lawsuit dealing with fraud and misrepresentation was simply not present.[148] The complaints accused the law schools of misrepresenting employment and salary statistics to law students; however, the representatives of the class had to prove that it was reasonable for them to rely on the numbers reported by the law school.[149] Without proof of the reasonableness of their reliance on

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from ABA-approved law school websites and found that there is a "continued pattern of consumer-disoriented activity." *Id*. at 2.

141. McEntee & Lynch, *supra* note 134. Law schools know from experience that applicants are optimistic about their future prospects and rarely consider that they may fall below the median for any data point. *Id*.

142. *Id.*

143. *See*, *e.g.*, *id.* ("In the 2003 edition of the 'ABA-LSAC Official Guide to Law Schools,' the school reported an 88.8 percent employment rate and only a 42 percent bar pass rate.").

144. Jack Crittenden & Elizabeth Ewing, *Fraud or Defamation?*, NAT'L JURIST, Sept. 2011, at 10.

145. *Id*.

146. *Id.*

147. *Id.*

148. *Id.*; Thomas Jefferson Complaint, *supra* note 128.

149. Crittenden & Ewing, *supra* note 144, at 10. This proposition relies on the assumption that the prospective law student was not obligated to do further research

those representations, the fraud claims were bound to fail. It was no secret that after the spring of 2007, law school applicants and administrators were aware, or should have been aware, that there was a downturn in employment for newly-minted lawyers, and thus, it would have been unreasonable for the applicants to believe or rely on any excessively optimistic predictions stemming from employment or salary statistics offered by the law schools at that time. Further, as Cooley President Don LeDuc said of his law school, it never "makes any promise or commitment about jobs for graduates, other than to say, [the school] provides placement counseling and assistance to graduates seeking to get jobs. And, of course, all who pass the bar are equipped with the necessary skills to begin a solo practice."[150]

C. Application on a Grander Scale

In 2004, four years before the onset of the recession, Richard Matasar, the former Dean of the New York Law School, made an unnerving observation about the future of American law schools:

> The great success of American legal education has been buoyed by cheap money, a perception that there are not many viable alternatives, a sense that a legal education is an excellent long-term investment, students' belief that they are the exception to any negative trends, and the historically accurate belief that the legal profession is so robust that it will always outrun the debt that students take to become lawyers. In the years to come, each of these trends will change substantially and jeopardize the legal academy.[151]

By 2011, it had become clear that for many law school graduates, outrunning the debt that they had taken on to become lawyers was unlikely to occur.[152] Many law students at that time had accumulated large amounts of debt to obtain a law degree under the impression that the employment

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and determine the meaning of the actual reported numbers. *Id.*

150. *Id.* at 9.

151. Michael C. Macchiarola & Arun Abraham, *Options for Student Borrowers: A Derivatives-Based Proposal to Protect Students and Control Debt-Fueled Inflation in the Higher Education Market*, 20 CORNELL J.L. & PUB. POL'Y 67, 117–18 (2010) (quoting Richard A. Matasar, *The Rise and Fall of American Legal Education*, 49 N.Y.L. SCH. L. REV. 465, 494 (2004)).

152. *See* discussion *supra* Part I.A.2. Additionally, it has been recognized that an "obvious effect" of the unnecessarily high "U.S. [law school] tuitions is to disproportionately screen out academically qualified potential applicants from less wealthy social backgrounds, except to the extent that these applicants can obtain sufficient scholarship assistance or are willing and able to draw heavily upon public or private sources of loan assistance." Crespi, *supra* note 36, at 37.

and salary data proffered by the law schools was accurate.[153] The class action suits that have been dismissed thus far all stand for the same premise—that the proof required to win a case based on perception and alleged misrepresentations is extremely difficult to generate. However, these lawsuits all shed light on a very serious issue that will be faced by former, current, and future law students—a dismal job market combined with increasing levels of debt.

IV. STUDENT LOAN DEBT PROVIDES ACCESS TO A LAW DEGREE, BUT MAY DENY A BAR LICENSE

For many students, loans are the primary means of access to a legal education.[154] Unfortunately, those same loans can, under certain circumstances, deny graduates admission to the practice of law.[155] Graduating from law school and gaining admission to a state bar is not a right but a privilege hedged in by a variety of conditions.[156] The practice of law is limited to those individuals whom a state bar determines to be truly qualified based upon education and certain moral characteristics.[157] All fifty states and the District of Columbia mandate some form of character qualifications as a precondition for admission to the practice of law.[158]

After graduating from law school, most law graduates apply for bar admission through at least one state's board of bar examiners.[159] Each state bar sets its own qualifications for attaining bar admission and licensing involves a demonstration of competence, a passing score on the bar examination, and an inquiry into the applicant's character and fitness.[160]

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153. *See* discussion *supra* Part I.C.

154. *See* discussion *supra* Part I.

155. *See* discussion *infra* Part IV.B.

156. Elizabeth Gepford McCulley, Note, *School of Sharks? Bar Fitness Requirements and the Role of Law Schools*, 14 GEO. J. LEGAL ETHICS 839, 841–42 (2001). Graduation from an ABA-accredited law school is a prerequisite to sitting for the bar in most states. *Frequently Asked Questions*, *Section of Legal Education and Admissions to the Bar*, AM. BAR ASS'N, http://www.americanbarassocationamericanbar.org/groups/legal_education/resources/frequently_asked_questions.htmlamericanbarassocation (last visited Feb. 11, 2014).

157. Justice Felix Frankfurter once observed, "all the interests of [humanity] that are comprised under the constitutional guarantee given to 'life, liberty and property' are in the professional keeping of lawyers." Jones, *supra* note 44, at 153.

158. *Id.* at 154.

159. For many states, the board of bar examiners is often "an agency of the highest state court in the jurisdiction, but occasionally the board is connected more closely to the state's bar association." *Basic Overview*, *Section of Legal Education and Admissions to the Bar*, AM. BAR ASS'N, http://www.americanbar.org/groups/legal_education/resources/bar_admissions/basic_overview.html (last visited Feb. 8, 2014) [hereinafter *Basic Overview*].

160. *Id.* In establishing one's qualifications to pass the character and fitness assessment, the burden is on the applicant. 7 C.J.S. *Attorney & Client* § 11 (2013).

The first requirement is to achieve a certain educational status, commonly a law degree from an ABA-accredited law school.[161] Having earned that degree establishes competence sufficient to satisfy bar standards.[162] The second requirement is the successful completion of a testing regimen consisting of two to three days of examinations.[163] Receiving a passing score on a state bar exam is another indication of legal competence.

The final requirement is a subjective analysis by the board of bar examiners, which seeks background information about each applicant that is deemed relevant to that applicant's receipt of a license to practice law.[164] The rationale behind this is that the purpose of the practice of law is to serve the public and that the harm that could potentially be inflicted on the public by an unscrupulous lawyer is a substantial concern that the board of bar examiners addresses through the character and fitness inquiry.[165] The applicant is required to disclose certain facts that pertain to his or her qualifications and any other facts that would notify the board of bar examiners of any potentially problematic aspects of the applicant's past.[166] In most states, the applicant's qualifications for character and fitness will typically be submitted to a board of bar examiners, whose findings on the applicant are merely advisory.[167] This advisory opinion is submitted to the state's court system, which has discretion to confirm or deny the board's assessment of an applicant's character and fitness.[168]

A. Character and Fitness Assessment and Law School Debt

Moral character as a professional credential for practicing law has had increasing importance in the legal profession over the last three centuries.[169] In eighteenth century England, the fitness standards for practicing law were based upon one's wealth and social standing.[170] The expenses involved in obtaining a legal education and in establishing a legal practice restricted access to the legal profession to those of a higher social

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161. Thirty-eight out of fifty-one jurisdictions do not require a J.D. degree from an accredited law school. AM. BAR ASS'N, COMPREHENSIVE GUIDE TO BAR ADMISSION REQUIREMENTS 2014, at 8–9 (2014), *available at* http://www.americanbar.org/content/dam/aba/publications/misc/legal_education/2014_comprehensive_guide_to_bar_admission_requirements.authcheckdam.pdf.

162. *Basic Overview*, *supra* note 159.

163. *Id.*

164. *Id.*

165. *Id.*

166. *Id.*

167. McCulley, *supra* note 156, at 842.

168. *Id.*

169. *See generally* Rhode, *supra* note 2, at 493.

170. *Id.* at 494.

class.[171] Over time, those standards changed as Parliament passed a statute that required five years of an apprenticeship and a judicial examination of fitness and capacity before practice in the legal field.[172]

During the formative years of the American Bar, the well-established British Bar gave little meaning to the concept of character and fitness as a professional credential to the practice of law.[173] In the American Bar, the moral requirement remained a staple in an otherwise unsettled admission process.[174] So, while educational standards have been changed and redefined over the years, the moral character requirement to practice law remains elusively undefined.[175]

1. Defining "Good Moral Character"

In 1957, Justice Hugo Black observed that "good moral character" is a term that is "unusually ambiguous" because of the limitless definitions that directly reflect the "attitudes, experiences, and prejudices of the definer," and that it is a qualification that is "easily adapted to fit personal views and predilections, [which] can be a dangerous instrument for arbitrary and discriminatory denial of the right to practice law."[176] Good moral character has often been approached with Justice Potter Stewart's "I know it when I see it" attitude because the Bar Examiner's Handbook recognizes that there is no formal definition of good moral character.[177]

Appropriately, good moral character is often defined negatively in terms of an absence of a proven act or attribute that is generally considered to prove moral turpitude.[178] It is also often defined positively by an applicant's "qualities of honesty, fairness, candor, trustworthiness, observance of fiduciary responsibility, respect for and obedience to the laws of the state and the nation and respect for the rights of others and for the judicial process."[179] Additional factors that courts may take into consideration in determining an applicant's character and fitness include

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171. *Id.*

172. *Id.* at 495. Eventually, a Society of Gentlemen Practisers was organized to improve the standards and admission of lawyers to the legal profession. *Id.* at 496.

173. *Id.*at 496.

174. *Id.*

175. *See, e.g.*, *id.* at 497 (discussing the disinterest of state bar associations in using moral character standards, except to withhold admission to the bar from women).

176. Konigsberg v. State Bar of Cal., 353 U.S. 252, 262–63 (1957) (Black, J., dissenting); Aaron M. Clemens, *Facing the Kleig Lights: Understanding the "Good Moral Character" Examination for Bar Applicants*, 40 AKRON L. REV. 255, 268 (2007).

177. Clemens, *supra* note 176, at 256–57 (citing Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring)).

178. *Id.* at 280.

179. 7 C.J.S. *Attorney & Client* § 16 (2013).

reliability, integrity, candor in dealing with licensing authorities, mental and emotional stability, strong family ties, and a good support system.[180] Moreover, a lack of fiscal responsibility, failure to be truthful to the board, and false or misleading statements are reasons for which a character and fitness application may be denied.[181]

There are numerous justifications for requiring an evaluation of an applicant's good moral character.[182] Some of the modern justifications rely on the relationship between an attorney and client, and the responsibility inherent in protecting the rights of the attorney's clients.[183] This justification relies on the understanding that the board of bar examiners certifies individuals who are capable of representing their clients honestly and competently, and that the board must feel confident in allowing the public to trust these individuals with their personal legal affairs.[184] The board should seek to define a more clear process or set of guidelines to determine the individuals who are capable of handling this responsibility so that applicants who seem likely to injure the public are rejected from admission to the bar and from the practice of law.[185]

2. The "Rational Relationship" Test

The United States Supreme Court has determined that "[a] State can require high standards of qualification, such as good moral character or proficiency in its law, before it admits an applicant to the bar, but any qualification must have a rational connection with the applicant's fitness or capacity to practice law."[186] Thus, in order to satisfy the Due Process Clause of the Fourteenth Amendment, a state may not utilize a factor to determine an applicant's good moral character, unless the factor has a "rational connection" to one's role as a lawyer.[187] The underlying concept is that an attorney, acting as an advisor, has a duty to treat the

180. Larry Craddock, *"Good Moral Character" as a Licensing Standard*, 9 TEX. TECH. ADMIN. L. J. 221, 232–33 (2008).

181. *Id.*

182. Clemens, *supra* note 176, at 267–68.

183. *Id.*

184. *Id.* Additionally, lawyers commonly deal with highly sensitive issues and information. *Id.*

185. *Id.* at 268.

186. Schware v. Bd. of Bar Examiners, 353 U.S. 232, 239 (1957).

187. *Id.* For instance, under this rule, the Court has found that, despite substantial doubts about an applicant's use of aliases and past records of arrests (none of which resulted in convictions), those issues were unrelated to the applicant's ability to practice law. *Id.* The applicant's exemplary conduct in law school proved that he was a well-suited candidate for bar admission. *Id.* Furthermore, it has been determined that although an applicant's "living arrangement may be unorthodox and unacceptable to some segments of society, [the] conduct bears no rational connection to [the applicant's] fitness to practice law." Cord v. Gibb, 254 S.E.2d 71, 73 (Va. 1979).

responsibilities entrusted to him or her with care. One way to determine a person's ability to manage this endeavor is to analyze one's ability to be financially responsible, which is thought to be rationally related to the practice of law.[188]

B. Reasonableness of Student Loan Debt in Conjunction with the Dismal Legal Economy

There was a point in time, between 2007 and early 2010, during which it was reasonable for entering law students to believe that they were likely to earn enough money as lawyers to pay off six-figure debts. However, that time span of reasonableness has ended. It is no secret that the current legal job market is anything but dismal for a significant fraction of each year's law school graduate cohort. It is unreasonable to believe that the current class of entering law students and future law students have the same beliefs about job prospects as those who have already entered the legal market or law school. It is the fact of membership among the previous cohort of law students (who entered school at a time when it was reasonable to believe that their anticipated debt burden would be manageable, given their expectation of lucrative employment) that should entitle applicants to forbearance during the character and fitness phase of the bar admission process, so long as these applicants can show that, upon admission to the bar, their plan for paying off their debt is feasible.

C. Exploring Determinations of Financial Irresponsibility

Many law students accumulate large amounts of debt in pursuit of a law degree, and some of them may not consider the future implications of that decision.[189] Not only does the current market for legal services create a formidable challenge to paying off student loan debt, but it could also prevent some individuals from gaining admission to the bar.[190] Accordingly, it has been suggested that the board of bar examiners of each state should reassess the Character and Fitness inquiry of the bar admission process.[191] Specifically, some have found that "[q]uestions regarding an applicant's. . .financial condition shed very little, if any, light on one's ability to practice law, and therefore should be eliminated from bar

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188. Bd. of Law Examiners v. Stevens, 868 S.W.2d 773 (Tex. 1994).

189. Susanna Kim, *Ohio Supreme Court Denies Law License for Grad with $170,000 in Student Loans*, ABC NEWS (Jan. 18, 2011), http://abcnews .go.com/Business/ohio-supreme-court-denies-law-license-law-grad/story?id=12 632984. *See* discussion *supra* Part I.A.1.

190. *Id.*

191. Donald H. Stone, *The Bar Admission Process, Gatekeeper or Big Brother: An Empirical Study*, 15 N. ILL. U. L. REV. 331 (1995).

applications."[192]

At least seventy-seven percent of all state boards inquire into an applicant's financial condition in the character and fitness evaluation.[193] Since 1836, a core concern of the legal profession has been whether an applicant could deal properly with client monies.[194] For that reason, an applicant who is unable to handle his or her own finances is typically viewed as "risky."[195] Court rulings on character deficiency that stem from financial irresponsibility have varied widely, as there are numerous ways that one might run afoul of that determination.[196] The standard that courts typically use in evaluating an applicant's financial responsibility is to determine if he or she has failed to make a "'genuine effort to meet one's [financial] responsibilities.'"[197] Failure to do so "can establish 'a lack of the character and integrity expected and required of one who seeks to become a member of the bar.'"[198]

For instance, in 2011, the New Hampshire Supreme Court gave equal weight to an applicant's debt of $138,000 and his history of criminal acts in deciding to disqualify him for admission to the bar.[199] The court rejected the applicant's argument that the only way to pay the student loan debt would be to gain employment as a lawyer, which would arguably allow the applicant to earn sufficient income.[200] The court acted on the premise that attorneys have a responsibility to their future clients to properly handle the client's money, saying that the fact that the applicant was unable "to recognize the significance of his own financial responsibilities does not engender confidence in his ability" to be an attorney.[201] This conclusion echoes the sentiment of a Florida court twenty years ago, which found that a "lawyer who is constantly in debt is more likely to succumb to

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192. *Id.* at 347.

193. *Id.* at 348.

194. Clemens, *supra* note 176, at 271. In 1836, David Hoffman published *Resolutions In Regard to Professional Deportment*, arguing that attorneys should not underbid other attorneys' legal fees; it is this sentiment that indicates "trade protectionism concerns" and other concerns involving the appropriate handling of clients' money. *Id* at 271 (citing Carol Rice Andrews, *Standards of Conduct for Lawyers: An 800-Year Evolution*, 57 SMU L. REV. 1385, 1428 (2004)).

195. *Id.* at 275. This concern has remained prevalent in the legal profession as many attorneys are disciplined for mishandling client funds and other financial misdeeds, like not paying child support, defaulting on student loans, and filing for bankruptcy. *Id.*

196. *Id.*

197. *Id.* (quoting George L. Blum, Annotation, *Failure to Pay Creditors as Affecting Applicant's Moral Character for Purposes of Admission to the Bar*, 108 A.L.R. 5th 289, § 2(b) (2003)).

198. *Id.*

199. *In re* G.W., 13 A.3d 194 (N.H. 2011).

200. *Id.* at 199.

201. *Id.* at 200.

temptations to the detriment of his or her clients or the public."[202]

Typically, debt level alone is not a completely disqualifying factor.[203] There have been numerous cases that stand for the proposition that the level of an applicant's debt can disqualify that individual from admission to the bar, but only if he or she lacks a feasible plan for the future repayment of that same debt.[204] For instance, a 2008 law school graduate who thrice failed the Ohio Bar Exam, Hassan Jonathan Griffin, was denied permission to retake the Ohio Bar Exam because his student loan debt totaled $170,000 and he had no established plan as a means of repaying such a large debt.[205] The court found that filing for bankruptcy was not a sufficient plan because this solution would only alleviate his consumer debts of $16,500, not his student loan debt of $170,000.[206] Thus, Mr. Griffin would gain no significant debt relief by declaring bankruptcy.[207]

Mr. Griffin's situation was similar to that of another law school graduate, Robert Bowman, who was denied admission to the New York Bar because of his student loan debt, totaling $430,000, and because he did not have a realistic plan for paying off that debt.[208] Robert Bowman's story is a cautionary tale that illustrates just how quickly student loan debt can increase. When Mr. Bowman graduated from law school, the amount of student loans he had encumbered totaled $270,000.[209] It was not until his loans were transferred from Sallie Mae that the collection agencies tacked on an additional $100,000 in fees, leaving Mr. Bowman with approximately $370,000 in student loans while his application for

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202. *In re* S.M.D., 609 So. 2d 1309, 1311 (Fla. 1992).

203. *Id.*

204. *See, e.g.*, *In re* Anonymous, 875 N.Y.S.2d 925 (N.Y. App. Div. 2009); *In re* Griffin, 943 N.E.2d 1008 (Ohio 2011); *In re* Kline, 877 N.E.2d 654 (Ohio 2007); Santulli v. Tex. Bd. of Law Examiners, No. 03-06-00392-CV, 2009 WL 961568 (Tex. Ct. App. Apr. 10, 2009).

205. *Griffin*, 943 N.E.2d at 1009. *See also* Rebecca Larson, *Law Grad Refused Bar Admission for Debt*, NAT'L JURIST (Feb. 14, 2011, 10:09 AM), http://www.nationaljurist.com/content/breaking-news/law-grad-refused-bar-admission-debt.

206. *Griffin*, 943 N.E.2d at 1008.

207. *Id.* at 1008–09. Mr. Griffin had failed the Ohio bar exam three times before the board's disqualification for bar admission based on his character and fitness assessment. *Id.* Mr. Griffin, in his forties at the time in question, graduated from The Ohio State University Moritz College of Law with $150,000 of student loan debt and an additional $20,000 from his undergraduate studies at Arizona State University. *Id.* Mr. Griffin also owed $16,500 on credit cards, but was working part time at a Public Defender's Office earning twelve dollars an hour. *Id. See supra* discussion Part I.C.

208. STATE OF N.Y. SUPREME COURT, APPELLATE DIV., THIRD JUD. DEP'T, SUBCOMM. ON CHARACTER AND FITNESS, RPT. ON ROBERT A. BOWMAN (2009), *available at* http://documents.nytimes.com/report-on-robert-a-bowman-s-application-for-admission-to-the-new-york-state-bar [hereinafter BOWMAN FITNESS REPORT].

209. *Id.*

admission to the bar was pending.[210] Mr. Bowman made contact with the student loan companies and was negotiating with Sallie Mae and the New York State Higher Education Services Corporation, both of which acknowledged that Mr. Bowman deserved some forbearance for his troubles with the companies.[211]

The subcommittee that evaluated Mr. Bowman's application concluded that he had "exceptional character, with exceptional perseverance, tenacity, and humility," and ultimately recommended him for admission to the bar.[212] However, the Appellate Division of the New York Supreme Court overruled the subcommittee's determination and found that Mr. Bowman was financially irresponsible.[213] The court made this determination knowing that Mr. Bowman's employment in the legal field was contingent upon admission to the bar and that the salary he would make as a lawyer would be enough to make substantial payments on his loan balance.[214] Nevertheless, the court reasoned that Mr. Bowman's student loan debt was too large and his efforts to repay them too meager for him to be a lawyer.[215] This approach to analyzing a candidate's financial irresponsibility has been criticized as "punishing anticipatory conduct rather than actual wrong-doing."[216]

V. MOVING FORWARD: CHANGING THE BOARD OF BAR EXAMINERS' FINANCIAL IRRESPONSIBILITY ANALYSIS AT THE CHARACTER AND FITNESS STAGE OF THE BAR APPLICATION

Each state's board of bar examiners should seek to remedy the injustices caused when the court punishes anticipatory conduct, rather than actual wrong-doing, in a multitude of ways. The first, and perhaps the simplest, way to fix the problem would be for each state to change the way its board of bar examiners analyzes bar applicants at the character and fitness stage, specifically dealing with the question of financial irresponsibility.[217] As

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210. *Id.* Sallie Mae overcharged Mr. Bowman, imposed hefty, unjustified fees, and kept Mr. Bowman from deferring his payments when he was legally entitled to do so. Jonathon D. Glater, *Finding Debt a Bigger Hurdle than Bar Exam*, N.Y. TIMES, July 2, 2009, at A1. Additionally, when Mr. Bowman contacted Sallie Mae for a medical deferment, the company transferred his private student loans to a collection agency, which tacked on an additional twenty-five percent fee. *Id.* The collection agency then transferred the loan again and that agency tacked on an additional twenty-five percent fee. *Id*. Mr. Bowman then found himself in a situation where his loans rapidly increased from $230,000 to $435,000. *Id.*

211. *Id.*

212. BOWMAN FITNESS REPORT, *supra* note 208.

213. *Id*.

214. *Id.*

215. *Id.*

216. Harris, *supra* note 1.

217. *See* discussion *supra* Part IV.

student loan debt continues to be a serious concern for law students, more prospective lawyers may be unable to gain admission to the legal profession because of the student loan debt encumbered during their educational endeavors, combined with the lack of realistic options for repaying that debt.[218] While it has been argued that the legal educational process and the legal profession as a whole needs a makeover,[219] one way for states to evolve and adapt to the changing legal climate is to change their treatment of student loan debt.

A. Student Loan Indebtedness Has No Rational Relation to One's Ability to Practice Law

The typical standard of good moral character is antiquated and has not evolved to adapt to economic change in the legal profession, specifically in the financial analysis portion of a candidate's application.[220] Law students, like many other Americans, have become accustomed to accumulating large amounts of debt as they prepare themselves for employment.[221] This reliance is unlikely to change unless the economy and the legal market, improve dramatically. As tuitions for both undergraduate institutions and law schools continue to increase in a struggling economy, it is likely that future law students rely even more heavily on student loans; consequently, more students will accumulate greater amounts of debt.[222]

The Supreme Court has acknowledged that a state bar may require applicants for admission to the bar to possess certain qualifying character traits, as long as those qualifications have a "rational connection" to the applicant's "fitness or capacity to practice law."[223] While financial questioning is rationally related to the practice of law because of the sensitive nature of dealing with client funds and in billing client hours, student loan indebtedness is typically not encumbered because of a person's irresponsibility.[224] In fact, student loans have been consistently viewed in a positive manner as a way to attain a better quality of life by

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218. *See* discussion *supra* Part IV.B.

219. In a recent online symposium at the Legal Ethics Forum, Professor Ray Campbell said that "[l]aw school as most of us know it is doomed." Ray Campbell, *The End of Law Schools*, LEGAL ETHICS FORUM (Feb. 8, 2012), http://www.legalethics forum .com/blog/2012/02/the-end-of-law-schools.html.

220. *Id.*

221. There is a growing trend in reliance on debt to finance many facets of American lives. *See*, *e.g.*, *U.S. National Debt Clock*, BABLYONTODAY.COM, http:// www.babylontoday.com/national_debt_clock.htm (last visited Feb. 07, 2014).

222. *See* discussion *supra* Part I.A.

223. Schware v. Bd. of Bar Exam'r, 353 U.S. 232, 239 (1957).

224. Past mishandling of client or organization funds, failing to make child support payments, student loan default, and bankruptcy filing are relevant to financial questioning because each of them evidence a form of irresponsibility that suggests poor moral character. *Id.*

investing in a student's future.[225] Credit card debt, on the other hand, is often encumbered from a variety of habits, generally linked to personal choice and not positively viewed.[226] Given such differences, student loan debt should not be treated the same as other varieties of debt or financial management problems in the eyes of a state board of bar examiners.

B. Financial Questions by Each State's Board of Bar Examiners Unjustly Burden Applicants with Significant Student Loan Debt at the Character and Fitness Stage of the Bar Application

In light of the increasing costs associated with attending an undergraduate college or university as well as law school, situations such as those faced by Mr. Bowman and Mr. Griffin may become relatively common.[227] Rising tuition costs increase the debt loads of many students who, in attending law school, are attempting to provide for a more secure future.[228] An anonymous student at Boston College Law School famously and poignantly observed in 2010 that "a J.D. seems to be more of a liability than an asset."[229] Unsurprisingly, the number of students who choosing to pursue a law degree began to decline that year and has continued to fall through the entering class of 2013.[230]

C. Treating Student Loan Debt Separately from Other Forms of Debt

Even if student loan debt proves to be a relevant consideration in analyzing a person's character, student loan debt and the repayment plan should be treated separately from the other forms of financial management. For instance, a person who neglects to pay child support, fails to file taxes, or writes bad checks has made a conscious decision to perform an action evident of poor moral character. On the other hand, a person who has accumulated student loans has not had the opportunity to display either the ability or inability to meet his or her financial obligations. Thus, student loan debt and a student's lack of a repayment plan should not give rise to an automatic determination of financial irresponsibility without giving the applicant the benefit of beginning his or her legal career and potentially

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225. Dwyer, *supra* note 50. *See also* discussion *supra* Part I.A.2.

226. Dwyer, *supra* note 50.

227. *See* discussion *supra* Part IV.A.

228. *See* discussion *supra* Part I.A.2.

229. Annie Lowrey, *A Case of Supply v. Demand*, SLATE.COM (Oct. 27, 2010, 4: 14 PM), http://www.slate.com/articles/business/moneybox/2010/10/a_case_of_supply_v_demand.single.html. In 2011, 87,900 candidates applied for law school, and 78,900 applied for admission in 2012. William D. Henderson & Rachel M. Zahorsky, *The Law School Bubble: How Long Will It Last if Law Grads Can't Pay Bills?*, 98 A.B.A. J. 30 (2012).

230. Lowery, *supra* note 229; Henderson & Zahorsky, *supra* note 229.

having the ability to make payments on that debt.[231] The applicants, similar to current lawyers, should be given the time and opportunity to handle their financial affairs responsibly.[232] Additionally, because student loan debt is typically not dischargeable in bankruptcy, a person who fails to meet the qualifications for admission to the bar because of a large debt load and the lack of a realistic plan for repayment has no real way to rectify the situation.[233] To complicate repayment further, it is estimated that approximately sixty-nine percent of all law students attain undergraduate degrees in two of the lowest-paying fields: humanities and social sciences.[234]

If student loan debt were treated separately from other forms of debt, the legal system would retain the power to discipline lawyers who fail to meet their financial obligations through disciplinary proceedings conducted by the relevant state bar. Furthermore, very large amounts of student debt may still lead to a determination of financial irresponsibility. However, that determination should be made after the individual in question has defaulted on his or her student loan payments and is incapable of honoring his or her own financial obligations, not merely because the applicant lacks a plan for repayment. This treatment of student loan debt through disbarment or other disciplinary consequences would demonstrate good faith on behalf of the board of bar examiners and would give applicants the benefit of the doubt until an irresponsible action has occurred that necessitates discipline.[235]

CONCLUSION

The class action suits against allegedly deceptive law schools have all been based thus far on the same premise: the proof required to win a case based on perception and alleged misrepresentations is nearly impossible. Regardless of the success of these lawsuits, one thing is clear: they shed light on a very serious issue that will be faced by former, current, and future law students—a dismal job market combined with increasing levels of debt. Those suits also prove that change is crucial because "[s]ix figures

231. Dwyer, *supra* note 50.

232. *Id.*

233. This assumes that the applicant would be unable to attain employment in a position that would enable him or her to substantially reduce the debt. The promise of a position upon admission to the Bar has proven an ineffective plan for repayment. *See In re* Anonymous, 875 N.Y.S.2d 925 (N.Y. App. Div. 2009). *See also* discussion *supra* Part I.C.

234. Michael Simkovic & Frank McIntyre, The Economic Value of a Law Degree, at Slide 22 (Apr. 13, 2013) (unpublished article with accompanying PowerPoint presentation), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2250585 (Sept. 2013).

235. The board should follow the criminal law approach in which one is presumed innocent until proven guilty.

of debt, a heavy interest burden and poor job prospects" are "no way to begin a legal career."[236] This change must occur to meet "the challenge to compete in a global economy [which] requires a higher education policy that honestly addresses issues of access, cost containment, and national interest."[237]

The treatment of financial questions by various state boards of bar examiners unjustly punishes applicants with significant student loan debt at the character and fitness stage of the bar application. A finding of financial irresponsibility based on an applicant's student loan debt and the absence of a good plan for repaying that debt is a determination that seeks to eliminate a future problem without the possibility of allowing the applicant to display financially responsible behavior. Numerous reform options exist that might allow law students to enjoy the prospect of a legal career. The solution proposed here recognizes that a difference exists between people who merely have significant debt obligations and who lack a realistic plan for meeting those obligations, and people who have demonstrated financial irresponsibility through actions such as defaulting on their student loans, failing to pay child support, and neglecting to file taxes.

236. Henderson & Zahorsky, *supra* note 230, at 35.
237. *Id.*

THE ISSUE OF DONOR STANDING AND HIGHER EDUCATION: WILL INCREASED DONOR STANDING BE HELPFUL OR HURTFUL TO AMERICAN COLLEGES AND UNIVERSITIES?

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> *"The cost of a Stanford education is not fully covered by tuition—all students are subsidized by the generosity of alumni, parents, and friends."*[1]

> *"Paying for a legal education might not be easy, but your invaluable support of the Notre Dame Law School allows our law students to focus on their legal studies a little more, and worry about paying for their education a little less."*[2]

> *"Every year, thousands of Vanderbilt alumni, parents and friends give, and these contributions help fund scholarships, support great faculty, and underwrite new academic programs."*[3]

> *"Annual gifts from alumni are the bedrock of Columbia's fundraising program and a measure of alumni support for the University. Current use funds, endowment, and bequests are welcomed."*[4]

INTRODUCTION

Every alumnus of a college or university is guaranteed two things when he or she graduates: a diploma and either a phone call or letter at least once a year from his or her alma mater asking for a donation. For many of us, we briefly thumb through the alumni magazine, smile at the pictures of the newly renovated library, and chuckle that Professor So-And-So is still teaching English 101. Then we write a nominal check to the school—in part out of nostalgia and loyalty, in part because of the tax deduction. But every once in a while, there is an alumnus who really puts a smile on the face of the president and the board of trustees by writing a very large check. Such a donation can mean expansion of the school's infrastructure, an increase in course and program offerings, new faculty, new facilities, new technology—all of which lead to a better education.

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1. *The Stanford Fund*, GIVING TO STANFORD, http://giving.stanford.edu/the-stanford-fund (last visited Apr. 15, 2014).
2. *Law School Annual Fund*, SUPPORTING NOTRE DAME, http://supporting.nd.edu/annual-giving/law-school-annual-fund/ (last visited Apr. 15, 2014).
3. *Vanderbilt Office of Annual Giving*, GIVING TO VANDERBILT, https://giving.vanderbilt.edu/annualgiving/ (last visited Apr. 15, 2014).
4. *College of Physicians and Surgeons*, Giving TO COLUMBIA, http://giving.columbia.edu/giftguide/college-physicians-and-surgeons (last visited Apr. 15, 2014).

As the above quotations suggest, colleges and universities depend heavily on the charitable support of alumni, parents, and friends for the operation of their schools. Larger gifts, however, tend to be accompanied with a purpose—and certain restrictions—that may give the trustees a headache to accompany their smile. Similarly, from the perspective of the donor of a sizeable amount of money, that warm feeling of giving out of college pride and gratitude may fade when the gift is not administered exactly as she had envisioned. What happens in such a case? Ultimately, the issue boils down to whether a donor may bring suit to enforce the terms of a charitable donation.

This Note will look broadly at the issue of donor standing—specifically, how it pertains to charitable donations to colleges and universities. Part I will look at the context of the issue of donor standing. Who gives to colleges and universities, and why do they do it? Part I looks anecdotally at large gifts given to various colleges and universities, and assesses the possible tax benefits which may serve as an impetus to give. Part II addresses the types of charitable donations that a person may make to a college or university, emphasizing that drafting a charitable donation in a certain manner can lead to very different legal outcomes. Part III addresses judicial characterization and enforcement of charitable donations and analyzes the case law that surrounds the issue of donor standing. It focuses on how similar donations have had divergent outcomes depending on the jurisdiction. Part IV analyzes the legislative side of the issue of donor standing, looking particularly at statutory divergence regarding how charitable donations are classified among various jurisdictions. Part V addresses possible ways to reconcile the jurisdictional differences on donor standing by looking to scholarly debate on the issue. Finally, this Note concludes by arguing that while changes in current legislation may help to create a more transparent system, they must be done in light of past judicial precedent. The title of this Note asks whether increased donor standing will be harmful or helpful to colleges and universities, and this Note concludes by answering: a little bit of both.

I. CONTEXT: WHO GIVES TO COLLEGES AND UNIVERSITIES, AND WHY DO THEY DO IT?

In 1991, a posthumous donation from Joseph A. Albertson to The College of Idaho resulted in an unusual phenomenon—the college changed its name to Albertson College of Idaho in honor of its generous alumnus and benefactor.[5] Albertson and his wife were consistently generous supporters of the college, and the 1991 donation enabled the school to build

5. *A Tradition of Philanthropy*, THE COLLEGE OF IDAHO, https://www.collegeofidaho.edu/giving/our-supporters/tradition-philanthropy (last visited Apr. 15, 2014).

several new buildings. The new buildings also bore the name Albertson.[6] While this might have seemed like a great tribute to the Albertson family, the name-change was actually met with a great deal of controversy among alumni, students, and the wider local community—many of whom ceased their financial support of the College in the ensuing years.[7] Finally in 2007, the Albertson family reached a mutual agreement with the school to undo the 1991 name-change. While the gift was beneficial to the school, it also had the negative side effect of costing the College the loss of significant support from entities other than the Albertson Foundation.[8] In fact, the Albertson family felt so strongly that the name-change hurt the school that the Foundation donated an additional $50 million to the small liberal arts college with the condition that the name be changed back to its original title.[9]

Across the nation, charitable donations are given to colleges and universities every year.[10] Larger gifts often come in the form of scholarships and endowments, sometimes created by a trust or through a contract subject to a condition subsequent. Often, such gifts are testamentary or made as a memorial, and thus are often contingent on specific interests of the testator or on the individual who is being memorialized. For example, Raymond G. Perelman said of his donation to the University of Pennsylvania, "I look at it as Penn Medicine gave me a gift. They offered me an opportunity to have my name on one of the best medical schools in the country."[11]

Naming rights may serve as a powerful impetus for charitable donations to colleges and universities. The (Albertson) College of Idaho controversy is just one of countless examples of generous benefactors having their name displayed on the marquees, buildings, and banners of institutes of higher education. Franklin & Marshall College was named for Benjamin Franklin, whose generous contribution in 1787 allowed the school to open its doors.[12] In 1936, a $2 million donation from alumnus Lucius N. Littauer—then the largest single gift from an individual donor to a college

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6. *Biographies: Joe Albertson*, J.A. AND KATHRYN ALBERTSON FOUNDATION, http://www.jkaf.org/the-foundation/biographies/ (last visited Apr. 15, 2014).

7. *A Tradition of Philanthropy*, *supra* note 5.

8. *Id.*

9. *Biographies: Joe Albertson*, *supra* note 6.

10. *See generally* Reid Kress Weisbord, *The Effects of Donor Standing on Philanthropy: Insights from the Psychology of Gift-Giving*, 45 GONZ. L. REV. 225 (2009).

11. Tamar Lewin, *Penn Gets $225 Million for its School of Medicine*, N.Y. TIMES, May 10, 2011, at A18.

12. *Mission and History*, FRANKLIN & MARSHALL COLLEGE, http://www.fandm.edu/about/mission-and-history (last visited Apr. 15, 2014). In fact, the school initially began as two separate colleges—Franklin College and Marshall College. *Id.* The two colleges eventually merged in 1853. *Id.*

or university—enabled Harvard to open its Graduate School of Public Administration, which was originally located in the Littauer Center on campus.[13] In 2005, Frank Eck's contribution of $21 million toward the expansion of Notre Dame Law School became the largest gift ever given to that law school—the fifth-largest gift ever received by the University—and led to naming the building the Eck Hall of Law.[14] As mentioned earlier, in 2011 Raymond G. Perelman and his wife Ruth donated $225 million to the University of Pennsylvania for its medical school, which was then renamed in their honor.[15] These examples are just the tip of the iceberg; when visiting any given school across the country, it is nearly impossible to find a building, a bench, a quadrangle, a library, or any other facility that does not bear the name of some generous benefactor.

Besides creating the warm feeling in one's heart and possibly the benefit of naming rights, donations to colleges and universities are appealing from the standpoint of a taxpayer. Colleges and universities are generally 501(c)(3) organizations under the Internal Revenue Code which may have beneficial tax consequences for taxpayers who make large donations.[16] Very often these donations come earmarked for a particular project: a specific building, a specific endowed chair, a memorial scholarship or fellowship. Many universities even have entire offices devoted to soliciting planned gifts of this targeted nature.[17]

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13. *History*, HARVARD KENNEDY SCHOOL, http://www.hks.harvard.edu/about/history (last visited Apr. 15, 2014). Today the school is known as The Harvard Kennedy School. *Id.* *See also Cornerstone for Littauer Center Laid by Founder*, THE HARVARD CRIMSON (May 11, 1938), http://www.thecrimson.com/article/1938/5/11/ cornerstone-for-littauer-center-laid-by/.

14. *The Dedication of Eck Hall of Law*, UNIV. OF NOTRE DAME (May 1, 2009), *available at* http://www3.nd.edu/~ndlaw/building_expansion/EckDedicationBrochure.pdf

15. Lewin, *supra* note 11.

16. I.R.C. § 501(a) (2006) and § 501(c)(3) provide tax exemption for educational institutions. § 501(c)(3)("Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or *educational purposes*. . . .[shall be exempt from taxation].") (emphasis added). *See also* I.R.C. § 2055(a)(2) ("[T]he value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises, or transfers—to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary or educational purposes."); Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593 (1999) (arguing that the shift of using corporate standards for charities has weakened fiduciary duties for enforcement and that this is exacerbated by recent tax laws favoring private foundations and diminishing the possibility of oversight).

17. *See, e.g.*, *The Charitable Remainder Annuity Trust*, SUPPORTING NOTRE DAME, http://nd.giftplans.org/index.php?cID=98 (last visited Apr. 15, 2014). *See also Planned Giving*, GIVING TO STANFORD, http://giving.stanford.edu/planned-giving (last visited Apr. 15, 2014) (providing guidelines on how to give to the school through bequests, life income gifts and other kinds of gifts including charitable lead trusts and donor

The creation of a trust can also have beneficial tax consequences. Colleges and universities can be the object of a charitable trust purpose according to the Restatement (Third) of Trusts.[18] Section 28 states, in relevant part: "Charitable trust purposes include: . . . (b) the advancement of knowledge of education."[19] Section 28 also distinguishes between public and private charitable purposes and notes that the fact that an institution charges tuition or fees does not prevent it from having a trust support its programs.[20] The comments in Section 28 describe the breadth of what can be defined as a charitable purpose, noting, "It does not matter . . . that, for example, only one student or two may receive a scholarship from the fund as long as the potential class of recipients will be drawn from an indefinite group . . . rather than from a group so narrowly defined (e.g., the settlor's descendants or relatives) as to make the trust a private trust."[21] While many gifts are certainly unrestricted, some are given with restrictions. Furthermore, donors often "expect a high degree of accountability for and loyalty to the restrictions they impose on charitable gifts."[22]

But what if this purpose is not carried out? What if it is not carried out in the way that the donor had intended? What if the purpose for which the donation was given is now obsolete? What if money was placed in an endowment for a medical school, but the university no longer has a medical school?[23] Can the endowment be repurposed for something else? If so, must the college or university even inform the donor of this change? Donative intent then becomes a tricky issue for donors and colleges and universities alike.

It may appear that the solution ought to be for the donor to sue the college or university to administer the gift as intended, but this is not always possible. The problem with this method of enforcement is the standing doctrine. When a court denies standing to a plaintiff of a suit to enforce the terms of a charitable donation, it "is merely a determination that the claim, however meritorious, should be asserted by someone else."[24] This issue is especially frustrating for donors in the area of charitable

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advised funds).

18. RESTATEMENT (THIRD) OF TRUSTS § 28 (2003).

19. *Id.*

20. *Id.* at cmt. a(1).

21. *Id.*

22. Reid Kress Weisbord, *Reservations About Donor Standing: Should the Law Allow Charitable Donors to Reserve the Right to Enforce a Gift Restriction?*, 42 REAL PROP. PROB. & TR. J. 245, 248 (2007) [hereinafter Weisbord, *Reservations*].

23. *See, e.g.,* L. B. Research and Educ. Found. v. UCLA Found., 29 Cal. Rptr. 3d 710 (Cal. Ct. App. 2005).

24. Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655, 658 (1998).

donations to colleges and universities, where the determination of what is best for the educational institution is sometimes at odds with the interests of the donor. Additionally, courts have not traditionally dealt with the issue of standing uniformly, nor have they employed the same legal theory when analyzing the gift itself.[25] Some courts have construed the charitable donation as a contract subject to a condition subsequent, allowing the donor to bring a claim when that condition has not been met, while others analyze it under property theories.[26] Still, other courts dismiss a case for lack of standing when the same facts in a different jurisdiction could have made it to trial.[27]

The Uniform Trust Code (UTC) provides some insight into the issue of donor standing.[28] Not all states have enacted the UTC, and even among those who have, there is a divergence in how it has been interpreted.[29] All this leads to a lack of clarity and consistency across states. This is especially problematic in the realm of colleges and universities, where donors give across state lines or to multiple institutions in different jurisdictions that do not analyze the issue similarly. Is it fair to allow a donor to enforce his charitable donation in one state while denying the same donor standing to enforce essentially the same donation in a different state? Conversely, should a college or university that happens to be in a state that has adopted the UTC be subject to litigation when a similarly situated institution in another jurisdiction would not be?

II. BACKGROUND: THE METHODS FOR MAKING A CHARITABLE DONATION

The issue of standing is one of the most fundamental aspects of litigation. In order to bring a claim, a plaintiff must have standing.[30] In order to show standing in a federal court, the plaintiff must prove three elements: 1) that an injury occurred; 2) that this injury was caused by the defendant; and 3) that a favorable judgment would redress this injury.[31] If the plaintiff does not meet one of these elements, there is no standing and the complaint is dismissed.[32] Standing may also be granted by statute.[33] In

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25. *See infra* Part III.

26. *Compare L. B. Research*, 29 Cal. Rptr. 3d at 716 (holding that the donor had standing to enforce the gift), *with* Hardt v. Vitae Found., Inc., 302 S.W.3d 133 (Mo. Ct. App. 2010) (holding that donors did not have standing to bring an action enforcing the gift).

27. *See, e.g.*, Pearson v. Garrett-Evangelical Theological Seminary, Inc., 790 F. Supp. 2d 759 (N.D. Ill. 2011) (dismissing the case for lack of donor standing).

28. *See infra* note 205 and accompanying text.

29. *See infra* Part IV.

30. JESSE DUKEMINIER, ROBERT H. SITKOFF & JAMES LINDGREN, WILLS, TRUSTS, AND ESTATES 541 (8th ed. 2008).

31. *United States v. Windsor*, 133 S. Ct. 2675, 2685–86 (2013).

32. *Id.*

cases involving charitable donations, the issue of standing separates cases that are litigated from the ones that are thrown out, no matter how meritorious the claim may be.[34]

Early on, charitable donations were classified solely under trust law.[35] A trust, at its most basic level, is a relationship in which one party holds property for the benefit of another party.[36] When a trust is made, a settlor divides a property interest—real or personal, tangible or intangible—between one or more beneficiaries and a trustee.[37] The trustee holds legal title to the interest while the beneficiary holds beneficial title, or equitable title in the interest.[38] The trustee must then manage the property for the benefit of the beneficiary.[39] A fiduciary duty is thus created between the trustee of a trust and the beneficiary of the trust.[40] Generally, an action can be brought by trust-beneficiaries for a breach of fiduciary duty.[41] Accordingly, the beneficiaries have an incentive to make sure that this duty is not breached because it affects them personally.[42] The enforcement of a trustee's fiduciary duty becomes more complicated when the trust in question is a charitable trust, as tends to be the case with gifts to colleges and universities.[43]

A charitable trust can be distinguished from a private trust by consideration of their respective beneficiaries. While private trusts must exist for the benefit of one or more ascertainable persons or entities, charitable trusts must exist for the benefit of a charitable purpose.[44] In a college and university setting, a charitable trust may benefit a very wide range of individuals, but not a specific individual or class of individuals.[45] Since charitable trusts have no ascertainable beneficiary to enforce the trust, the role of enforcement falls to the attorney general as *parens patriae* to protect the general public.[46] Thus, if the charitable trust were not carried out according to the terms of the trust, the settlor would have no power to

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33. *Id.*
34. *Id.*
35. Gary, *supra* note 16, at 595.
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.*
41. *Id.*
42. *Id.*
43. *Id.*
44. Sanford J. Schlesinger & Martin R. Goodman, *Enforcement of Charitable Transfers: A Question of Standing*, 36 ESTPLN 37 (2009). There are instances in which someone with a "special interest" in the trust's enforcement can be determined. *Id.* In such cases, the individual with the "special interest" is granted standing. *Id.*
45. Gary, *supra* note 16, at 596.
46. *Id.*

enforce the trust in court.

Settlor enforcement of trusts is codified in Section 405(c) of the Uniform Trust Code, which states, "The settlor of a charitable trust . . . . may maintain a proceeding to enforce the trust."[47] As of publication of this Note, twenty-four states and the District of Columbia allow donors standing by formally adopting the UTC,[48] while other states have recent legislation or judicial opinions that allow donors to have standing. [49] The problem arises from among the other twenty-six states.[50] To complicate matters even further, charitable gifts are not always given in the form of trusts. Charitable gifts can be classified in multiple ways and may be treated under both property law and contract law.[51]

A restricted gift can be analyzed under four legal theories: 1) as a charitable trust; 2) as a conditional gift; 3) as a restricted gift to corporate charity; or 4) as a contract subject to a condition subsequent.[52] Property law governs the first three options while contract law governs the fourth option.[53]

A. Charitable Trusts

As previously noted, a charitable trust is similar to a private trust, but rather than benefiting a particular ascertainable beneficiary who may bring suit to enforce the trust, a charitable trust must be for the benefit of a charitable purpose. The state attorney general is the principal party with standing to enforce the terms of the charitable trust.[54] The traditional rule is that the only way in which a settlor may have standing to enforce the terms of the trust is if the settlor retains an interest in the trust property.[55] In 1959, this rule was articulated in Restatement (Second) of Trusts Section 391, which states:

> A suit can be maintained for the enforcement of a charitable trust by the Attorney General or other public officer, or by a co-trustee, or by a person who has a special interest in the enforcement of the charitable trust, but not by persons who have

47. UNIFORM TRUST CODE § 405(c) (2010).

48. *See infra* note 206.

49. *See, e.g.*, Smithers v. St. Luke's Roosevelt-Hosp. Ctr., 723 N.Y.S.2d 426 (N.Y. App. Div. 2001) (holding that the settlor's wife, as special administratix, had standing to bring an action enforcing the charitable trust).

50. *See, e.g.*, *id.*

51. Evelyn Brody, *From the Dead Hand to the Living Dead: The Conundrum of Charitable-Donor Standing*, 41 GA. L. REV. 1183, 1190–91 (2007) (hereinafter Brody, *Dead Hand*).

52. *Id.*

53. *Id.*

54. DUKEMINIER, SITKOFF & LINDGREN, *supra* note 30, at 751.

55. *Id.* at 785.

> no special interest *or by the settlor or his heirs, personal representatives or next of kin.*[56]

The Restatement (Third) of Trusts Section 94 reflects a modern shift in the traditional understanding by removing the final sentence of the Second Restatement's provision.[57] This change allows a settlor to bring an enforcement suit regardless of whether or not an interest is retained in the property:

> (2) A suit for the enforcement of a charitable trust may be maintained only by the Attorney General or other appropriate public officer or by a co-trustee or successor trustee, by a settlor, or by another person who has a special interest in the enforcement of the trust.[58]

Because enforcement by the attorney general has shown itself to be an inadequate enforcement mechanism, the recent trend has been towards allowing donors standing.[59] In jurisdictions that have not adopted the UTC, the judge's choice of either adopting the traditional rule of the Second Restatement or the modern rule found in both the Third Restatement and the UTC plays a crucial role in standing.

Under the traditional rule, a settlor is unable to bring a claim if the donated funds in question are used in a way that goes against his intentions unless he or she expressly reserves some sort of property interest in the gift.[60] But reserving that property interest can also result in negative tax

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56. RESTATEMENT (SECOND) OF TRUSTS § 391 (1959) (emphasis added). *See cf. Smithers*, 723 N.Y.S.2d 426; L. B. Research and Educ. Found. v. UCLA Found., 29 Cal. Rptr. 3d 710 (Cal. Ct. App. 2005).

57. RESTATEMENT (THIRD) OF TRUSTS § 94(b) (2012).

58. *Id.*

59. GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 415 (2012). *See, e.g.*, Holt v. Coll. Of Osteopathic Physicians & Surgeons, 394 P.2d 932, 935 (Cal. 1964) ("The Attorney General may not be in a position to become aware of wrongful conduct or to be sufficiently familiar with the situation to appreciate its impact, and the various responsibilities of his office may also tend to make it burdensome for him to institute legal actions except in situations of serious public detriment."). *See also* Brody, *Dead Hand*, *supra* note 51, at 1244 (quoting MARION FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 333 (2004) ("The overriding factor in almost every one of the cases in which individuals were granted standing was the *lack of effective enforcement by the attorney general* or other government official") (emphasis added); Terri Lynn Helge, *Policing the Good Guys: Regulation of the Charitable Sector Through a Federal Charity Oversight Board*, 19 CORNELL J. L. & PUB. POL'Y 1, 20 (2009) ("Government entities lack adequate funding and qualified personnel to enforce existing laws. Very few states attempt to ensure that charitable fiduciaries obey their duties of loyalty and care.").

60. Schlesinger & Goodman, *supra* note 44, at 37. This is further exacerbated by the fact that many charitable donations are given, in part, because of the tax deduction the settlor could potentially be able to take. Such deductions may be limited if the settlor in fact retains some sort of property interest for himself. *Id.* at 40.

consequences for the settlor.[61] If the settlor reserves no interest for himself, the traditional rule holds that the state attorney general has standing as *parens patriae* to bring a case, but there is no guarantee that he or she will choose to do so.[62] This is in part because the attorney general is generally not personally affected by the misuse of the funds and therefore has less of an incentive than the settlor to actually ensure that the charitable trust is being administered according to its terms.[63] Likewise, attorneys general are not always the best situated to redress a problem because of political considerations, which may motivate them not to pursue the enforcement of certain charitable trusts.[64] Finally, the attorney general of a given state has limited resources and—especially in an era where state governments are increasingly affected by severe budgetary constraints—may not deem it prudent to divert these resources towards enforcing charitable trusts.[65]

B. Conditional Gifts

The second way in which a restricted gift can be classified is as a conditional gift.[66] Conditional gifts differ from charitable trusts in that donors have the ability to sue for the return of the property in instances where the conditions of the gift are not satisfied.[67] The Restatement (Third) of Trusts, Section 5(h) specifies that conditions and equitable charges do not result in trusts.[68] The Comments in that subsection further explain that when a donor gives a conditional gift to another person, and the gift recipient "commit[s] or fails[s] to perform a specified act, the transferred interest shall be forfeited."[69] The Comment further distinguishes a conditional gift from a trust by noting that no fiduciary relationship is created by the condition and therefore beneficiaries of the gift have no standing to enforce the condition.[70] In sum, donors—but not beneficiaries—of conditional gifts have standing to sue over problems with enforcement. Whether or not a gift is conditional requires a fact-based

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61. *Id.*

62. Gary, *supra* note 16, at 596.

63. *Id.* at 37.

64. *See, e.g.*, *In re* Milton Hershey Sch., 911 A.2d 1258 (Pa. 2006) (holding that the alumni association did not have a special interest to vest it with standing).

65. Schlesinger & Goodman, *supra* note 44, at 39. *See also*, Helge, *supra* note 59, at 21–22 ("In a majority of states, staffing levels dedicated to oversight of the charitable sector are minimal and having remained relatively static for over forty years.").

66. Brody, *Dead Hand*, *supra* note 51, at 1201–02.

67. *Id.* at 1191–92.

68. RESTATEMENT (THIRD) OF TRUSTS § 5(h) (2003).

69. *Id.*

70. *Id.*

inquiry into the donor's intent at the time that the gift was made.[71]

C. Restricted Gift to a Corporate Charity

The third theory of analysis once again falls under property law and is called a restricted gift to a corporate charity.[72] Treatment of restricted gifts to corporate charities differs amongst the states, but the ultimate effect is the same.[73] Some states classify the charitable nonprofit corporation as a trust with the board of directors as trustees while others treat the charitable class served by the corporate charity as trust beneficiaries.[74] Ultimately, the result is that only the attorney general may enforce the terms of the gift except in extremely unusual cases.[75] Because charitable donations to colleges and universities are not typically classified under this heading, this Note will not delve into any further detail regarding restricted gifts to corporate charities.

D. Contract Subject to a Condition Subsequent

Finally, a contract subject to a condition subsequent is analyzed under contract law. If there is a condition in the contract, the contract may be frustrated by the occurrence or non-occurrence of the stipulated event.[76] This type of restricted gift is unequivocally analyzed under contract principles.[77] The problem with viewing a donative transfer as a contract subject to a condition subsequent, however, is that many such transfers are testamentary dispositions and not bargained-for exchanges; so it can easily become problematic to construe them as contracts.[78]

E. Conclusion

The fact that there are so many different methods under which a court can analyze any given gift leads not only to confusion among different jurisdictions, but also to a major divergence among the kinds of cases in which donor standing is recognized and those in which it is not. In some ways, the inconsistencies and confusion between jurisdictions may indicate that the current legal regimes courts have for this analysis are insufficient to truly resolve the issue.[79]

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71. *Id.*
72. Brody, *Dead Hand*, *supra* note 51, at 1191.
73. *Id.* at 1206.
74. *Id.* at 1206–07.
75. *Id.* at 1209.
76. *Id.* at 1202–03.
77. *Id.*
78. *Id.* at 1192.
79. *Id.* at 1258–74 (arguing for legislation to permit "giftracts").

Additionally, the ability to analyze a case under so many legal theories leads to several different types of remedies available to plaintiffs—assuming that they are even granted standing. While specific performance of the terms of the gift could be ordered if the gift were classified under property law, it may be more likely for the remedy to be damages if the gift was seen as a contract. Different remedies in different jurisdictions also have the potential to encourage forum shopping when possible.

III. JUDICIAL CHARACTERIZATION AND ENFORCEMENT OF CHARITABLE DONATIONS

There are a series of key cases that illustrate the divergent practices of donor standing. In the 2011 Illinois case, *Pearson v. Garrett-Evangelical Theological Seminary*,[80] the court dismissed with prejudice Pearson's amended complaint against the seminary for administering a scholarship, the funds for which Pearson had donated.[81] In 1997, a Connecticut court in *Carl J. Herzog Foundation, Inc. v. University of Bridgeport*[82] determined that unless a donor reserves a property right in the gift, he does not have standing to sue.[83] In the 2001 New York case, *Smithers v. St. Luke's-Roosevelt Hospital Center*,[84] the court decided that the settlor did have standing.[85] In the 2005 California case, *L.B. Research and Education Foundation v. UCLA Foundation.*, the court determined that the gift in question was a contract subject to a condition subsequent and not a charitable trust.[86] For that reason, the donor had standing to sue.[87] However, the court in this case stated that even if it had been a charitable trust, the donor would still have standing to sue.[88] In contrast, four years later in *Hardt v. Vitae Foundation, Inc.*, the Missouri State Appellate Court distinguished the case from *L.B. Research* by strictly construing the UTC, as adopted by Missouri, to refer only to trusts.[89] For that reason, the court determined that the donors did not have standing.[90] Most recently, in the 2013 Maryland case *Newell v. Johns Hopkins University*,[91] the court held that a use restriction clause in a sale contract limited the scale or density of

80. 790 F. Supp. 2d 759 (N.D. Ill. 2011).
81. *Id.*
82. 699 A.2d 995 (Conn. 1997).
83. *Id.*
84. 723 N.Y.S.2d 426 (N.Y. App. Div. 2001).
85. *Id.*
86. 29 Cal. Rptr. 3d 710 (Cal. Ct. App. 2005).
87. *Id.* at 712.
88. *Id.* at 717.
89. 302 S.W.3d 133 (Mo. Ct. App. 2009).
90. *Id.* at 135.
91. 79 A.3d 1009 (Md. Ct. Spec. App. 2013).

the University's planned development of the land.[92] In essence, current law is far from uniform among the states and it is unclear under which type of instrument (trust or contract) a donor will have standing to sue, if at all.

The *Herzog* case serves as one of the first modern instances of standing in the context of a charitable donation.[93] On August 12, 1986 the Carl J. Herzog Foundation agreed "to participate in a matching grant program that would provide need-based merit scholarship to disadvantaged students for medical related education."[94] On September 9, 1986, the University of Bridgeport formally accepted the offer of a matching grant of up to $250,000 and, upon raising the $250,000, the Foundation paid the agreed upon amount.[95] The grants were allegedly used for the agreed upon purpose—specifically to fund scholarships for students in the University of Bridgeport's nursing program—until the University closed its nursing school on June 20, 1991.[96] The Foundation learned of the nursing school's closure on November 21, 1991.[97]

The Foundation then brought an action seeking injunctive relief to enforce the provisions of the restricted charitable gift, but the case was dismissed for lack of standing.[98] When the Foundation appealed, the intermediate appellate court reversed and remanded the case.[99] The University then appealed to the Connecticut Supreme Court, which reversed the intermediate appellate court's judgment.[100] The main issue on appeal was whether or not the Connecticut Uniform Management of Institutional Funds Act ("CUMIFA") established "statutory standing for a donor to enforce the terms of the completed charitable gift."[101] Ultimately, the court held that the legislature did not intend to establish donor standing

92. *Id.*

93. 699 A.2d 995 (Conn. 1997). *See generally* Paula Kilcoyne, *Charitable Trusts—Donor Standing Under the Uniform Management of Institutional Funds Act in Light of* Carl J. Herzog Foundation, Inc. v. University of Bridgeport, 21 W. NEW ENG. L. REV. 131 (1999).

94. Carl J. Herzog Found., Inc. v. Univ. of Bridgeport, 699 A.2d 995, 996 (Conn. 1997).

95. *Id.* The plaintiff transferred $144,000 to the defendant on June 26, 1987 and the remaining $106,000 on June 28, 1988. *Id.*

96. *Id.*

97. *Id.*

98. Carl J. Herzog Found., Inc. v. Univ. of Bridgeport, 13 Conn. L. Rptr. 622 (Conn. Super. Ct. 1995), *rev'd*, 41 Conn. App. 790 (Conn. App. Ct. 1996), *rev'd*, 699 A.2d 995 (Conn. 1997) ("CUMIFA, pursuant to which the plaintiff has brought this action, does not provide the plaintiff with the right to enforce restrictions contained in the "gift instrument," and therefore the plaintiff lacks standing.").

99. Carl J. Herzog Found., Inc. v. Univ. of Bridgeport, 41 Conn. App. 790 (Conn. App. Ct. 1996), *rev'd*, 699 A.2d 995 (Conn. 1997).

100. Carl J. Herzog Found., Inc. v. Univ. of Bridgeport, 699 A.2d 995 (1997).

101. *Id.* at 996.

in such cases.[102]

The court's analysis in this case focused on the fact that the grantor had retained no property interest in the gift instrument and thus was denied standing under the traditional rule of charitable trusts.[103] The court held that "a donor who has made a completed charitable contribution, whether as an absolute gift or in trust, had no standing to bring an action to enforce the terms of his or her gift or trust unless he or she had expressly reserved the right to do so."[104] The court first emphasized that, at common law, the plaintiff would have no standing and, before analyzing the Foundation's case under CUMIFA, highlighted the role of the attorney general in enforcing the charitable purposes of a gift.[105] The Foundation conceded that nothing in the plain language of the statute granted donor standing.[106] However, the Foundation argued that Section 45a–533, which provides for the governing board of a charitable institution to be released from any part of a gift restriction with written consent of the donor, would not make sense if the donor were denied standing to bring a claim when the restriction was ignored without written consent.[107] The Connecticut Supreme Court ultimately determined that the intent of the legislature was not to allow statutory donor standing.[108] CUMIFA was ultimately repealed in 2008.[109]

In *L.B. Research*, the California court analyzed the donative transfer under contract law.[110] In July 2000, L.B. Research and Education Foundation had made a $1 million donation to the UCLA Foundation to establish the Julien I.E. Hoffman, M.D., Chair in Cardiothoracic Surgery.[111] Both foundations settled on the gift, and the basic provision of the gift was that the fund would "be used by Chair holders who met specified criteria to 'support basic science research activities that may have the potential for clinical applications.'"[112] The terms of the gift also contained the language:

> [I]f the Cardiothoracic Surgery program shall cease to exist at UCLA, or in the event that UCLA does not meet the terms and

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102. *Id.*

103. *Id. See also* Ronald Chester, *Grantor Standing to Enforce Charitable Transfers Under Section 405(c) of the Uniform Trust Code and Related Law: How Important is it and How Extensive Should it Be?*, 37 REAL PROP. PROB. & TR. J. 611, 615–16 (2003).

104. *Carl J. Herzog*, 699 A.2d at 997.

105. *Id*. at 998–99.

106. *Id.* at 999–1000.

107. *Id.*

108. *Id.* at 996.

109. C.G.S.A. § 45a-527, §§ 45a-526–529 (repealed 2008).

110. 29 Cal. Rptr. 3d 710 (Cal. Ct. App. 2005).

111. *Id.* at 716–17.

112. *Id.*

> conditions of this agreement, any and all funds shall be transferred to support an endowed chair in Cardiothoracic Surgery . . . in the Department of Surgery at the University of California, San Francisco, School of Medicine.[113]

An additional provision provided that if the Department of Surgery ceased to be, then the funds in question would be transferred to another university within the University of California system to support an endowed chair under the same terms.[114] In 2003, the L.B. Research Foundation sued for the enforcement of this gift.[115] UCLA answered that the L.B. Research Foundation had no standing to bring such a claim. UCLA argued that only the attorney general was able to bring an enforcement action in the case of a charitable trust.[116] The trial court agreed with UCLA regarding standing and threw the case out.[117]

On appeal by the Foundation, the appellate court held that the gift was a contract subject to a condition subsequent.[118] For that reason, the appellate court reversed the trial court and remanded the case.[119]

This opinion was not received without controversy. Evelyn Brody criticizes the legal analysis employed by the California Court of Appeals for confounding the enforcement options available whether the gift was classified under contract or property law.[120] Ultimately, Brody argues that "[t]he courts' increased and continued confusion over what law to apply to private enforcement of charitable gifts suggests that the existing legal classifications are not working."[121] Instead of trying to fit the round peg of restricted gifts into the square hole of existing trust or contract law, Brody suggests the creation of a new hybrid legal regime to address what she dubs "giftracts."[122]

In contrast to *L.B. Research*, a Missouri court in *Hardt*,[123] held that the donor did not have standing under the UTC, the Uniform Prudent Management of Institutional Funds Act, or common law.[124] In this case, Edwin and Karl Hardt were two executors of the estate of Selma J. Hardt.[125] They were given the discretion to distribute the remainder of her

113. *Id.* at 712.
114. *Id.* at 712–13.
115. *Id*. at 713.
116. *Id.*
117. *Id.*
118. *Id.* at 716.
119. *Id*. at 717.
120. Brody, *Dead Hand*, *supra* note 51, at 1191.
121. *Id.* at 1274.
122. *Id.* at 1189.
123. 302 S.W.3d 133, 140 (Mo. Ct. App. 2009).
124. *Id.* at 140.
125. *Id.* at 135.

estate to a charitable organization of their choice.[126] In March of 2001, the Hardts met with representatives of Vitae—a pro-life, non-profit charitable organization—to arrange a donation of the estate's remainder to that organization.[127] They met with Vitae's National Project Director and President who presented a proposal regarding air media campaigns in the top twenty-five media markets in the United States.[128] Vitae explained that this campaign was vital to Vitae's mission because it was the most effective way to reach women vulnerable to having abortions, and that Vitae lacked sufficient funding to reach ten of the markets identified.[129] Ultimately, Vitae was granted funding of $4,242,000, which was the total amount that Vitae had identified as needed for air media campaigns in the ten regions.[130] The money was accompanied with a letter of intent that specified the ten markets and also explained that the gift was to be used as a challenge gift, which would require Vitae to match any contributions Vitae received from other sources.[131] The intent letter also clearly indicated that the funds "will not be fully consumed in the initial media campaign but will be the basis for establishing an ongoing presence in these markets."[132] In November of 2002, an additional $4 million was given to Vitae, of which $3 million was to be used as matching gifts while the other $1 million was to be used to develop a website aimed at teens.[133]

The gift was allegedly not administered according to the Hardts' plan, as portions that were intended to act as matching gifts were used instead for hiring new staff members and other administrative expenses.[134] By June 2005, the Hardts learned through accountings from Vitae that the gift had allegedly been misused significantly with nearly half spent on administrative expenses while other portions had been spent on media markets not listed in the 2001 gift.[135] On August 6, 2008, the Hardts filed a petition requesting a detailed accounting of both the 2001 and 2002 gifts, a restoration of any portion of either gift not spent on its allotted purpose, an injunction preventing any further misuse of the gifts, or transfer of the gift to another charitable organization that the Hardts would choose.[136] Vitae filed a motion to dismiss on the grounds that the Hardts lacked standing,

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126. *Id.*
127. *Id.*
128. *Id.*
129. *Id.*
130. *Id.*
131. *Id.* at 135–36.
132. *Id.* at 136.
133. *Id.*
134. *Id.*
135. *Id.* at 136.
136. *Id.*

which the trial court granted.[137]

The appellate court affirmed the trial court's decision, classifying the gift as a charitable gift.[138] The only person with standing to bring a claim to enforce a charitable gift would be the attorney general or a beneficiary with a "special interest."[139] The court held that in order for the Hardts to have standing, they would have had to make the gift subject to a condition subsequent—in which case, they would have retained some interest for themselves with the ability to bring suit to protect that interest.[140] The court also rejected the notion that the gift could be classified as a contract.[141]

Likewise, the 2011 *Pearson* case[142] was dismissed for lack of standing.[143] In 2006, Thomas L. Pearson pledged to donate to the Garrett-Evangelical Theological Seminary three installments of $400,000—totaling $1.2 million—for the purpose of funding the "Pearson Scholarship."[144] Named in honor of Pearson's parents, this scholarship was intended to support only "upcoming generations of Garrett students who were among the brightest young scholars and who planned to undertake the same pastoral ministry work in Iowa to which Richard and Ramalee had dedicated their lives."[145] The gift also contained language providing that if Garrett could not find students to "fulfill this objective," the funds would be transferred to DePauw University in Greencastle, Indiana to set up a similar scholarship program there.[146] After four years, Garrett was allegedly unable to meet the terms of the gift but did not transfer the gift to DePauw as instructed. For that reason, the Pearson family brought the matter before the court, and Garrett responded with a motion to dismiss for a lack of standing.[147]

The district court, citing Illinois caselaw, agreed with Garrett.[148] It quoted, in particular, a 79-year-old Illinois appellate case that stated: "[A] mere donor to a fund creating a trust for a public charity cannot call the trustees of that fund to an account for a misapplication of the fund, or any

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137. *Id.* at 135–37.

138. *Id.* at 140.

139. *Id.*

140. *Id*.

141. *Id.* at 140.

142. 790 F. Supp. 2d. 759 (N.D. Ill. 2011).

143. *Id.* at 769. *Pearson* was a federal case brought in Illinois on the grounds of diversity of citizenship.

144. *Id.* at 761.

145. *Id.* at 762.

146. *Id.*

147. *Id*. Garrett also sought to dismiss the complaint for lack of subject-matter jurisdiction but the court disagreed with this. *Id.*

148. *Id*.

breach of the trust, unless there is something peculiar in the transaction beyond the mere fact of contribution."[149] The court granted that this alone was not dispositive, but, because Pearson was also arguing that the gift was a contract, there was still room for him to bring an enforcement action.[150] Relying on *Herzog*, however, the court held that the transfer was a completed gift and thus Pearson had no interest left to justify standing.[151]

Similarly, in November 2013, the Maryland Court of Special Appeals decided *Newell v. Johns Hopkins University*[152]—a case illustrating the importance of carefully drafting the donative instrument to best effectuate the donor's intent.[153] In 1989, Elizabeth Banks—a prominent Maryland citizen who was known for her opposition to uncontrolled development in Montgomery County[154]—conveyed her family farm to Johns Hopkins University.[155] Various assessments placed on the farm property made retaining the property cost prohibitive for Banks.[156] She had good relations with Johns Hopkins and felt they would respect her wish that the farm not be densely developed.[157] With this in mind, Elizabeth Banks entered into a contract of sale with the University to convey the property in exchange for her being able to live the rest of her life on the farm.[158] The conveyance was a sale-and-gift transaction in which Banks sold the property to the University for well under the fair market value and "intend[ed] to make a charitable contribution to the Buyer to the extent of the excess of the actual fair market value."[159] At the time of conveyance, Johns Hopkins paid $5 million for the property which was valued at $54 million.[160]

However, within two decades of the gift, Johns Hopkins began to develop the land in a way that the Banks family alleged was not in accordance with Elizabeth's donative intent. In 2010, Johns Hopkins

149. Smith v. Thompson, 266 Ill. App. 165, 182 (Ill. App. Ct. 1932).

150. *Pearson*, 790 F. Supp. 2d at 764.

151. It should be noted that *L.B. Research* is an appellate decision; at the trial level it was dismissed for lack of donor standing.

152. 79 A.3d 1009 (Md. Ct. Spec. App. 2013).

153. *Id.*

154. Lori Aratani, *Johns Hopkins Sued Over Plans For Belward Farm*, WASH. POST (Jan. 31, 2012), http://www.washingtonpost.com/local/johns-hopkins-sued-over-plans-for-belward-farm/2012/01/31/gIQAEPXAgQ_story.html ("Local lore has it that Elizabeth Beall Banks once chased developers off her Gaithersburg area farm with a shotgun when they came around asking questions.").

155. *Newell*, 79 A.3d at 1011.

156. *Id.* at 1010–11.

157. *Id.*

158. *Id.*

159. *Id.* at 1012.

160. Lori Aratani, *Johns Hopkins Lawsuit Highlights Questions About Schools' Obligations to Donors,* WASH. POST (Feb. 20, 2012), http://www.washingtonpost.com/local/trafficandcommuting/johns-hopkins-lawsuit-highlights-questions-about-schools-obligations-to-donors/2012/02/17/gIQAVMH0PR_story.html.

received zoning approval to build a 4.7 million square foot development on the property.[161] This differed substantially from the original Master Plan that Elizabeth Banks supported.[162] Finalized in 1997, the original Master Plan would have created a satellite campus with low profile buildings, totaling only 1.4 million square feet.[163] The contract of sale, signed in 1989, contained a use restriction clause specifying that the farm be used "for agricultural, academic, research and development, delivery of health and medical care and services, or related purposes only."[164] The heirs of Elizabeth Banks[165] filed suit, alleging that the use restriction clause prohibited Johns Hopkins from developing the property in accordance with the 2010 Master Plan.[166] The issue of the lawsuit was how this clause impacted Johns Hopkins' fee simple title.[167]

Throughout the opinion, it is made clear that although Johns Hopkins was developing the land in a way that was allegedly at odds with Elizabeth Banks' intent when she conveyed the property to the University, this was immaterial.[168] Despite the development allegedly being in opposition to the donor's intent, the court of special appeals affirmed the lower court's grant of summary judgment to Johns Hopkins because the contract had retained no property right to Banks.[169] The court held that the sale-and-gift was a valid contract, stating, "[T]he fact that she came to disapprove of [Johns] Hopkins's evolving plans for the Farm does not create a right in the Family to insert new limits into the Contract now."[170] Finally, the court expressed quite clearly that alleged donative intent cannot constrain a contract when property is given in fee simple, stating, "[a] bad deal does not mean a void deal, and whatever issues the Family has with [Johns] Hopkins's long-term management of the Farm, it cannot now hold Hopkins accountable for parameters that Ms. Banks may (or may not) have had in mind that went unexpressed in the Contract."[171]

By contrast, *Adler v. SAVE*,[172] an August 2013 appellate decision from New Jersey, held that a charity that solicits and accepts donations is

161. *Id.*
162. *Id.*
163. *Id.*
164. *Newell*, 79 A.3d at 1010.
165. Ms. Banks passed away on January 17, 2005. OBITUARY OF ELIZABETH BEALL BANKS, http://www.scale-it-back.com/files/obituary_of_elizabeth_beall_banks_website.pdf (last visited Apr. 15, 2014).
166. *Newell*, 79 A.3d at 1010.
167. *Id.*
168. *Id*.
169. *Id.* at 1024.
170. *Id.* at 1023.
171. *Id.*
172. 74 A.3d 41 (N.J. Super. Ct. App. Div. 2013).

required to return the donation when it is used in a manner inconsistent with the purpose for which the donation was made.[173] In that case, Bernard Adler and his wife made a donation in the form of a conditional gift to SAVE, an animal shelter that did not euthanize.[174] Between 2002 and 2004, the Adlers donated $50,000 (in various installments) to be used exclusively for a capital expansion project that would create more space for larger dogs and older cats, in exchange for naming rights.[175] However, in February 2006, SAVE announced that it was merging with another charitable organization and, as a result, would not be building the new facility as planned.[176] The Adlers requested the return of their donation and were denied.[177] They subsequently filed suit.[178]

The trial court held in favor of the Adlers, ordering the full return of the charitable gift.[179] On appeal, SAVE argued that the donation was not a conditional gift, and, in the alternative, that even if it were classified as a conditional gift, the condition had been or would be met.[180] The appellate division found neither of these arguments compelling and affirmed the lower court decision.[181] The court characterized the defendant charity as "wooing" the Adlers into giving money through the use of "sophisticated weapons of persuasion"—namely brochures and presentations featuring "happy children and their family [sic] warmly embracing puppies, kittens, and vulnerable-looking older animals."[182] Without New Jersey precedent regarding the return of an inter vivos gift, the court decided that, out of fairness, it was only right that SAVE return the gift in full.[183]

When viewed together, these cases demonstrate the current divergence among jurisdictions as to how charitable donations are classified. Additionally, these different classifications produce wildly different remedies. Even in cases where the state's statutory scheme does not permit donor standing, the *L.B. Research* court demonstrates that the judiciary has the power to permit donor standing and will exercise that power.[184]

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173. *Id*. at 43.

174. *Id.*

175. *Id.* at 47.

176. *Id.* at 49. A new facility would still be built, but it would be at a different location and of substantially different size and character. *Id.* The new building site, additionally, did not allow the Adlers to have naming rights, nor was it specifically dedicated to sheltering larger dogs and older cats. *Id.*

177. *Id.*

178. *Id.*

179. *Id.* at 53.

180. *Id.*

181. *Id.*

182. *Id.* at 54.

183. *Id.* at 55.

184. *See generally* L.B. Research and Educ. Found. v. UCLA Found., 29 Cal. Rptr. 3d 710 (Cal. Ct. App. 2005).

Perhaps this trend towards increased donor standing is favorable for donors, but from the perspective of a college or university it may lead to burdensome litigation.

Both Princeton University and the University of Southern California have had recent disagreements regarding the proper allocation of funds leading to protracted litigation.[185] In 1961, Marie Robertson made a donation of A&P stock worth $35 million to Princeton University's Woodrow Wilson School of Public and International Affairs in honor of her husband Charles Robertson, who was an alumnus of the school.[186] For tax reasons, it was agreed that the gift would be administered through the Robertson Foundation—a foundation that would be brought into existence for the sole purpose of administering the gift—and that Princeton University would control this administration.[187] The governance structure of the Foundation provided that four of the seven members would be from Princeton University.[188] The remaining three members of the board were Marie's children.[189] In 2002, Marie's children filed suit when they disagreed with the direction of the Foundation.[190] Among their requests, the Robertson children wanted to narrow the Foundation's mission and give the plaintiffs control over the Foundation.[191] Ultimately, after six years of expensive litigation, the parties settled[192]—dissolving the Robertson Foundation and creating instead the Robertson Fund, an endowed fund with Princeton as the sole controller.[193] This effectively divested the Robertson children of any property interest in the gift and also effectively removed their standing to bring suit on the gift in the future.

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185. *See* Weisbord, *Reservations*, *supra* note 22, at 254–58.

186. *Robertson Lawsuit: Background*, PRINCETON UNIVERSITY (Jan. 31, 2013, 5:36 PM), http://www.princeton.edu/robertson/about/background/ [hereinafter *Robertson Lawsuit*].

187. *Id. See also* Letter from Robert F. Goheen, Comm'r of Internal Revenue, to Princeton University (May 1, 1961), *available at* http://www.princeton.edu/robertson/documents/docs/Pres_Goheen_letter_5-1-61_to_the_IRS-ex1.pdf [hereinafter *Letter to Princeton*].

188. *Letter to Princeton*, *supra* note 187.

189. *Robertson Lawsuit*, *supra* note 186.

190. *Id.*

191. Robertson v. Princeton Univ., No. C-99-02, 2007 WL 7687561 at *17 (N.J. Super. Ct. Ch. Div. 2007).

192. *Settlement Retains Princeton's Control, Use of Robertson Funds*, PRINCETONUNIVERSITY (Dec. 10, 2008 9:00 AM) [hereinafter *Use of Robertson Funds*], *available at* http://www.princeton.edu/robertson/statements/viewstory.xml?storypath=/main/news/archive/S22/81/66C43/index.xml ("Princeton's attorneys estimate that each party to the litigation likely would have incurred additional legal expenses in excess of $20 million to continue to prepare the case for trial, conduct the lengthy trial and pursue any subsequent appeals").

193. Agreement of Settlement, Robertson v. Princeton Univ., No. C-99-02 (N.J. Super. Ct. Ch. Div. Dec. 9, 2008), *available at* http://www.princeton.edu/robertson/documents/docs/Robertson_Settlement_Agreement-Executed.pdf.

While the Robertson Foundation example is not entirely comparable with other cases mentioned in this Note, because there was no question of donor standing,[194] it is illustrative of the integral role of charitable donations to colleges and universities and the potential effects on educational programs from litigation.[195] It also illustrates the potential nightmares in the future that can arise from the way a restricted gift is given. Princeton University's Vice president and Secretary Robert K. Durkee said of the Robertson Foundation's governance structure, "[s]uch a mechanism can help sustain the interest of the donor and the donor's advisers, but there are other ways to achieve this goal without introducing a structure that confers corporate obligations and standing to sue that ordinarily would not be available to donors of restricted gifts."[196] By reserving some level of control—even if not a majority—in the donor and later the donor's children by creating a corporate structure, the Robertson Foundation set itself up for litigation in the event the trustees one day disagreed. Durkee further describes the potential pitfalls of such a structure ultimately frustrating donor's intent: "This mechanism becomes even more problematical when participation passes from the founding generation—which has a personal connection to the terms they agreed to in making the gift—to later generations that may bring to the table a different agenda for the use of the funds."[197]

Likewise, the University of Southern California also recently settled a lawsuit involving a large gift.[198] In early 1995, the Paul F. Glenn Foundation announced a $1.6 million gift to create an endowed chair for cellular and molecular gerontology research.[199] The Foundation's mission is "to extend the healthy productive years of life through research on the mechanisms of biological aging."[200] In 2001, when Paul Glenn learned that the funds were not being used as he had intended, he filed suit—claiming that he had entered into a contract as opposed to giving the funds outright

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194. Because the three children of the donor were also trustees of the Foundation, they had standing to sue their co-trustees.

195. While Princeton's experience did not have devastating consequences for the University, other colleges or universities with smaller endowments and less alumni support may not be so lucky in similar situations.

196. Robert K. Durkee, *Letter to the Editor of the Chronical of Higher Education and Chronicle of Philanthropy—Updated*, PRINCETONUNIVERSITY (Jan. 26. 2009 12:22 PM), *available at* http://www.princeton.edu/robertson/statements/viewstory.xml?storypath=/main/news/archive/S23/29/90M60/index.xml.

197. *Id.*

198. Weisbord, *Reservations*, *supra* note 22, at 257–58.

199. James Lytle, *A Chair For Young Scientists to Study Aging*, USC NEWS (Feb. 27, 1995), *available at* http://www.usc.edu/uscnews/stories/1058.html.

200. GLENN FOUNDATION FOR MEDICAL RESEARCH, http://www.glennfoundation.org/ (last visited Mar. 4, 2014).

to the University.[201] The parties ultimately settled, but unlike the Princeton case where the University was able to retain the gift, the consequences for USC were suboptimal, as the Glenn gift was transferred to Harvard University instead.[202] At that time the gift was valued at $5 million.[203]

IV. STATUTORY DIVERGENCE: DIFFERENT RULES IN DIFFERENT JURISDICTIONS

As has previously been mentioned,[204] Section 405 of the UTC permits a donor to bring a claim to enforce a charitable trust.[205] At the time of this writing, the UTC has been enacted in twenty-four states plus the District of Columbia.[206] This means that roughly half the states have not enacted the UTC, including, notably, four of the top five most populous states in the union: California, New York, Texas, and Illinois. This does not mean, however, that donor standing to enforce the terms of a charitable trust is unavailable in those states.

In California, the court has addressed the issue of donor standing.[207] The California Government Code Section 12598(a) provides: "The primary responsibility for supervising charitable trusts in California, for ensuring compliance with trusts and articles of incorporation, and for protection of assets held by charitable trusts and public benefit corporations, resides in the Attorney General."[208] As is evidenced in *L.B. Research*, rather than changing the traditional rule regarding enforcement of a charitable trust, at

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201. *See* Weisbord, *Reservations*, *supra* note 22, at 258; Alan F. Rothschild, Jr., *How Donors May—And May Not—Exercise Control of Charitable Gifts*, *in* TAXATION OF EXEMPTS 113–14 (2004).

202. Weisbord, *Reservations*, *supra* note 22, at 258.

203. *Id.*

204. *See supra* Part II.

205. UNIFORM TRUST CODE § 405 (2000).

206. *See* ALA. CODE § 19-3B-405(C) (2007); ARIZ. REV. STAT. ANN. § 14-10405(C) (Supp. 2008); ARK. CODE ANN. § 28-73-405(c) (Supp. 2007); D.C. CODE § 19-1304.05(c) (Supp. 2009); FL. STAT. ANN. § 736.0405 (Supp. 2009); KAN. STAT. ANN. § 58a-405 (2005); MASS. GEN. LAWS ANN. § 405(c) (West 2012); ME. REV. STAT. ANN. TIT. 18-B, § 405(3) (Supp. 2008); MICH. COMP. LAWS § 700.7405(3) (2009); MO. ANN. STAT. 456.4-405 (West 2007); NEB. REV. STAT. § 30-3831 (2008); N.H. REV. STAT. ANN. §564-B:4-405(c) (2007); N.M. STAT. § 46A-4-405(C) (2007); N.C. GEN. STAT. § 36C-4-405.1 (2007); N.D. CENT. CODE § 59-12-05(3) (Supp. 2009); OHIO REV. CODE ANN. § 5804.05(A) (West 2007); OR REV. STAT. § 130.170(3) (2007); 20 PA. CONS. STAT. ANN. § 7735(c) (West Supp. 2009); S.C. CODE ANN. § 62-7-405(c) (2009); TENN. CODE ANN. § 35-15-405 (2007); UTAH CODE ANN. § 75-7-405(3) (Supp. 2008); VT. STAT. ANN. TIT. 14A, § 405(c) (Supp. 2009); VA. CODE ANN. § 64.2-723 (West. 2012); W. Va. Code, § 44D -4-405(2011); WYO. STAT. ANN. § 4-10-406(c) (2007) [hereinafter UTC States].

207. *See, e.g.*, L. B. Research and Educ. Found. v. UCLA Found., 29 Cal. Rptr. 3d 710 (Cal. Ct. App. 2005).

208. CAL. GOV'T. CODE § 12598 (West 2005).

least one California intermediate court has chosen to construe such a gift as a conditional gift.[209] Likewise, in New York, *Smithers v. St. Luke's-Roosevelt Hospital Center* is still persuasive authority.[210] What this shows is that even without the adoption of the UTC, some courts have taken an active role in expanding donor standing.

Even in those states that have adopted the UTC, there remains room for interpretation. Section 405 contains language that the settlor "among others" has power to enforce the trust.[211] Paragraph 4 in the comments of Section 405 allows for the state attorney general to still bring an action, even in cases where donor standing is found.[212] This can be read to simply expand the traditional rule recognizing standing in attorneys general and those with a special interest, but it leaves open a gray area for jurisdictions to expand the category of those with standing even further. Wyoming, for example, is a state that has adopted the UTC, and in *Hicks v. Dowd*[213] the Wyoming Supreme Court held that "a charitable trust may be enforced by a settlor, the attorney general, or a qualified beneficiary of the trust."[214] The "qualified beneficiary" was determined to be analogous to "special interest" and thus the only change to the traditional rule in Wyoming is that the settlor is added to the list of charitable trust enforcers.[215]

This type of expansion of the category of trust enforcers may seem to have a limited scope, but it is somewhat vague as to what rights in terms of assignability the settlor may have. Joshua C. Tate addressed this issue in his 2010 article *Should Charitable Enforcement Rights Be Assignable?*[216] Mr. Tate argued that jurisdictions that choose to analyze charitable trusts from a contractarian perspective and permit the assignment of such contractual rights might actually expand the number of persons able to bring enforcement claims in the future.[217]

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209. L. B. Research and Educ. Found. v. UCLA Found., 29 Cal. Rptr. 3d 710, 716 (Cal. Ct. App. 2005).

210. 723 N.Y.S.2d 426 (N.Y. App. Div. 2001).

211. UNIFORM TRUST CODE § 405 (2000).

212. *Id.* ("Contrary to Restatement (Second) of Trusts Section 391 (1959), subsection (c) grants a settlor standing to maintain an action to enforce a charitable trust. The grant of standing to the settlor does not negate the right of the state attorney general or persons with special interests to enforce either the trust or their interests").

213. 157 P.3d 914 (Wyo. 2007).

214. *Id.* at 921 (holding that resident was not a qualified beneficiary of the trust and therefore had no standing to bring an enforcement action, nor was the enforcement of the trust of such great public interest as to give the resident standing).

215. *Id.* at 921. *See also* Joshua C. Tate, *Should Charitable Trust Enforcement Rights Be Assignable?*, 85 CHI.-KENT L. REV. 1045 (2010) (arguing that enforcement rights of charitable trusts should, to some extent be assignable).

216. Tate, *supra* note 215.

217. *See generally id*.

> At least with regard to the issue of assignability, courts applying UTC § 405(c) and similar provisions need not write on a blank slate. In cases like

Although fewer than half of the states have formally adopted the UTC, there is still a general shift in the United States that seems to be in favor of increasing donor standing through legislative measures or judicial constructions of gift instruments to grant standing. But is this the proper trajectory for the law governing donative transfers? Is expanding standing—and otherwise construing gift instruments in such a way as to enable donors to enforce them—the best policy?

V. IS THERE A WAY TO FIX THE PROBLEM OF DONOR STANDING?

A. Trust as Contract Law

In 1995, John Langbein wrote an article about viewing trust law from a contractarian basis.[218] He traced the development of the trust law in the United States historically and said that, when trust law initially came into common usage in the 14th century, contract law had not yet advanced enough to adequately deal with trust purposes.[219] According to Langbein, "[i]f . . . in the fourteenth century our law of contract had taken its modern form, I think that the courts of law would have been compelled to say 'Yes, here is an agreement; therefore it is a legally enforceable contract.'"[220] Langbein argued that trust law ought to be construed as contract law as opposed to property law because, although trust property is required in order for there to be a trust, the fundamental feature of a trust is "the trust deal that defines the powers and responsibilities of the trustee in managing the property."[221] Langbein further stated:

> Sometimes the trust deal also confers significant discretion upon the trustee over dispositive provisions, that is, in allocating the beneficial interests among the beneficiaries. The settlor and the trustee may express their deal in detailed terms drafted for the particular trust, or they may be content to adopt the default rules of trust law. Either way, *the deal between settlor and trustee is functionally indistinguishable from the modern third-party-*

> Hicks, a reasonable assignment of the settlor's enforcement right could further the goal of effective supervision that was the original impetus for settlor standing. . . . while assignment may not be appropriate in every case, recognizing a general principle of assignability would serve the greater purpose of holding charitable trustees accountable for their actions. . . . Thus, the answer to the question posed in the title of this Article is a qualified "yes."

Id. at 1071–72.

218. *See generally* John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625 (1995).

219. *Id.* at 632–35.

220. *Id.* at 634, *quoting* FREDERIC W. MAITLAND, EQUITY: A COURSE OF LECTURES 28 (John Brunyate rev. ed., 2d ed. 1936).

221. Langbein, *supra* note 218, at 627.

beneficiary contract. Trusts are contracts.[222]

Langbein addressed some of the reasons for which trust law was specifically distinguished from contract law in the Restatement (Second) of Trusts[223]—including the common law differences of remedy—but argued that this rationale is obsolete in an era where specific performance has grown more common as a remedy in contract law.[224]

Since the *Herzog* opinion, there has been a significant amount of scholarly work on this issue as well as legislative attempts to find a solution for how to characterize charitable donations.[225] Section 405(c) of the UTC has done some work to mitigate the plight of the donor, but it also leaves unanswered questions as to how far the power to enforce should go. Could it be assignable or inherited?[226] Additionally, while Section 405(c) has increased benefits for donors, is this detrimental to the trustees of charitable trusts? Will increased donor standing increase nuisance suits? In many ways, these are questions that only time will be able to answer, but the possible implications of increased donor standing certainly include adverse effects to those who are responsible for administering a charitable gift. In the context of colleges and universities, increased donor standing has the potential to divert time, attention, and money away from the institution's primary educational purposes in order to deal with litigation.

B. Finding Solutions Through Legislation

Reid Kress Wiesbord argues that donors should be granted a limited right to sue for the enforcement of the terms of their gift and that this

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222. *Id.* (emphasis added).

223. RESTATEMENT (SECOND) OF TRUSTS § 197, cmt. b (1959) ("The creation of a trust is conceived of as a conveyance of the beneficial interest in the trust property rather than as a contract.").

224. Langbein, *supra* note 218, at 653. At common law, the "presumptive mode of relief" was damages as opposed to specific performance while specific performance was a routine remedy for property law. *Id.*

225. *See, e.g.*, Pearson v. Garrett-Evangelical Theological Seminary, Inc., 790 F. Supp. 2d 759, 765 (N.D. Ill. 2011) (declining to extend the *Herzog* analysis). *See also*, Russell v. Yale Univ., 737 A.2d 941, 946 (Conn. App. Ct. 1999) (discussing the application of *Herzog* in a case about a charitable trust to the Yale divinity school); Paula Kilcoyne, *Charitable Trusts-Donor Standing Under the Uniform Management of Institutional Funds Act in Light of Carl J. Herzog Foundation, Inc. v. University of Bridgeport*, 21 W. NEW ENG. L. REV. 131, 134–35 (1999) (discussing "the interpretation of donor standing under CUMIFA by both the Connecticut Supreme Court in *Herzog* and the Connecticut Appellate Court it overruled"); Lisa Loftin, *Protecting the Charitable Investor: A Rationale for Donor Enforcement of Restricted Gifts*, 8 B.U. PUB. INT. L.J. 361, 364 (1999) (arguing that by "denying charitable investors the standing to bring an action to enforce the terms of a charitable gift, courts provide donee colleges and universities with virtually unchecked power to disregard the gift-giver's intent").

226. *See, e.g.*, Tate, *supra* note 215.

should be accomplished through legislative reform.[227] Citing recent examples of donor enforcement actions—such as the Robertson Foundation's $35 million gift to Princeton University's Woodrow Wilson School of Public and International Affairs[228] and the Paul F. Glenn Foundation's $1.6 million gift to the University of Southern California for gerontology research[229]—Weisbord notes more parties are settling prior to trial, in part out of fear of negative publicity.[230]

In the case of colleges and universities, especially, fear of losing such a gift raises concerns about the ability to continue certain academic programs.[231] Additionally, litigation—even when a case is ultimately settled—can divert significant resources away from a college or university's primary goal of education. Princeton University President Shirley M. Tilghman said of the Robertson Lawsuit, "[i]t is tragic that this lawsuit required the expenditure of tens of millions of dollars in legal fees that could have and should have been spent on educational and charitable purposes."[232] Weisbord ultimately accepts that granting donor standing is becoming more prevalent and suggests that legislation should be introduced to decrease vagueness rather than allowing courts to determine how standing should be treated.[233] Weisbord envisions legislation that allows donors standing, but requires donor plaintiffs to meet a high burden of proof in order to avoid vexatious litigation.[234]

Ronald Chester, meanwhile, focuses on the inadequacy of the attorney general alone for enforcement.[235] He argues that grantors, whether donors or settlors, should have standing to enforce the restrictions of the gift because state attorneys general have largely been unsuccessful in policing abuses in the charitable sector.[236] As he explains: "One key difference in

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227. Weisbord, *Reservations*, *supra* note 22, at 245.

228. *See Robertson Lawsuit Overview*, *supra* note 186.

229. Weisbord, *Reservations*, *supra* note 22, at 257–58.

230. *Id.* at 254.

231. *See, e.g. Use of Robertson Funds*, *supra* note 192. In response to the six year lawsuit that ultimately concluded favorably for the school Princeton University President Shirley M. Tilghman stated:

> This settlement achieves the University's highest priorities in this lawsuit, which were to ensure that Marie Robertson's gift will continue to support the graduate program of the Woodrow Wilson School and that the University would have full authority to make academic judgments about how these funds are to be used.

Id.

232. *Id.*

233. Weisbord, *Reservations*, *supra* note 22, at 296–97.

234. *Id.*

235. Ronald Chester, *Grantor Standing to Enforce Charitable Transfers Under Section 405(c) of the Uniform Trust Code and Related Law: How Important is it and How Extensive Should it Be?*, 37 REAL PROP. PROB. & TR. J. 611 (2003).

236. *Id.* at 612.

enforcement mechanisms available in the for-profit as opposed to the charitable sector is that the latter must rely almost entirely on government, whereas the former can rely on the self-interest of private shareholders, beneficiaries, and corporation members to augment government efforts."[237]

Chester also addresses the general lack of effectiveness in existing enforcement mechanisms.[238] He argues that "the problem with applying private trust fiduciary law to charitable trusts is that there are no principals to enforce the fiduciary duties of agents."[239] Chester emphasizes the need for reform and posits that expanding standing would not lead to nuisance suits that would distract charities from their charitable purposes.[240] He addresses this common argument that increased standing would encourage individuals to sue trustees in order to get their way by pointing to recent legislative attempts that target increasing transparency within charitable organizations.[241] Ultimately, he claims that these attempts at increased transparency will mitigate the frequency of nuisance suits because donors will have knowledge of how their gift is being administered and charitable organizations will have more of an incentive to allocate funds according to the terms of the gift.[242]

Chester also notes that while changes to the legal framework for grantor standing seemingly would be better suited for legislatures to address, recent attempts have failed.[243] He notes that "recent federal attempts at comprehensive legislation have faltered politically, largely because a considerable segment of the public and the lawmakers they elect believe that internal policing of this sector is best."[244] Essentially, the fear is that too much regulation of charitable institutions would create a chilling effect by "unduly penaliz[ing] important individuals who are seen as 'doing good.'"[245] Chester argues that because charities are so often seen as "doing good" because their missions are not for profit, there is little desire on the

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237. Ronald Chester, *Improving Enforcement Mechanisms in the Charitable Sector: Can Increased Disclosure of Information Be Utilized Effectively?*, 40 NEW ENG. L. REV. 447, 451–52 (2006) [hereinafter Chester, *Enforcement Mechanisms*].

238. *Id*. at 456.

239. *Id*.

240. *Id*.

241. *Id.* at 461–63. Specifically, Chester looks at the California Nonprofit Integrity Act, effective January 1, 2005, which focused on increasing the transparency of charitable operations and accountability of those in charge of them.) *Id.* at 463. The California Non-Profit Integrity Act of 2004 amended Cal. Bus. & Prof. Code § 17510.5 and Cal. Gov't Code §§ 12581-12586, 12599, 12599.1 and added Cal. Gov't Code 12599.3, 12599.6 12599.7. The Act was amended in 2006 to revise Cal. Gov't Code §§ 12585, 12599, 12599.1, 12599.2.

242. Chester, *Enforcement Mechanisms, supra* note 237, at 461–63.

243. *Id.* at 452.

244. *Id.*

245. *Id.* at 452–53.

part of the public to regulate their inner workings.[246] He cites numerous examples of reported abuses in the charitable sector and contends that regulation is in fact necessary.[247] If the legislature fails to act, the courts will be the only ones situated to improve private "enforcement" of proper standards.[248] He also argues that they should do so by expanding standing for both donors and for "specially interested" beneficiaries.[249]

C. The "Giftract"

Evelyn Brody has written prolifically on the topic of donor standing.[250] Her 2007 article *From the Dead Hand to the Living Dead: The Conundrum of Charitable-Donor Standing*, first lays out the four major ways to analyze donative transfers before launching into a discussion of the problems each of these analyses presents.[251] She argues that neither traditional charitable trust law nor pure contract law provide an effective framework for addressing donor standing and proposes a hybrid approach in the form of a "giftract."[252] This proposed "giftract" would allow a donor to spell out what sort of rights they wish to retain—including standing—while still being cognizant of public policy concerns on individuals ordering charitable institutions around.[253] Brody believes it is the best approach because, in her view, the existing legal classifications are not working and are leading to disparate results.[254] Finally, Brody concludes that legislation to create a "giftract" may be the best way to deal with the increased confusion and inconsistency amongst courts.[255]

The differences between *L.B. Research* and *Hardt* demonstrate a

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246. *Id.* at 468–69.

247. *Id.* at 453–55.

248. *Id.* at 453.

249. *Id.*

250. *See also*, Evelyn Brody & John Tyler, *Respecting Foundation and Charity Autonomy: How Public is Private Philanthropy?*, 85 CHI.-KENT L. REV 571 (2010) (arguing that foundations are not inherently public but that the potential for abuses warrants a degree of state regulation); Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937 (2004) (discussing how private parties determine whom a given charity is intended to serve and how this affects the attorney general's ability to protect the "public"). *See generally*, Brody, *Dead Hand*, *supra* note 51 (arguing that the "courts' increased and continued confusion over what law to apply to private enforcement of charitable gifts suggests that the existing legal classifications are not working" and that to rectify this confusion, legislatures should establish a specific legal regime for donative transfers that would solve the problem of enforcement without giving the donor too much control over the gift after it has been given.).

251. Brody, *Dead Hand*, *supra* note 51, at 1186–93.

252. *Id.* at 1258–61.

253. *Id.* at 1274.

254. *Id.*

255. *Id.* at 1258–74.

disturbing fact about the lack of consistency and transparency among various jurisdictions regarding donor standing.[256] The facts of the two cases are roughly the same. In each case, a gift with a specified purpose was allegedly not carried out in the manner that the donor of the gift intended it to be and was brought before a court to be enforced. In *L.B. Research*, the gift was found to be a contract and therefore enforceable. In *Hardt*, the gift was found to be a charitable trust and thus only the attorney general would have the standing to bring such a case. If the Hardts had brought their case before a California court, there could have been a dramatically different outcome.

When the stakes are so high, why would we deny a donor the standing to enforce the terms of his gift? In *Hardt*, the gift was worth upwards of $8 million—with a significant portion allegedly misused, not simply to target a different media market, but also to completely rework the organization's strategy with extreme administrative expenses. If we continue to deny donors standing to enforce gifts, would this not lead to a decrease in charitable donations? If a donor cannot be certain that an organization will use the funds granted to it in the manner the donor intends, would this not in turn make donors less likely to give to non-profit organizations, which depend on the generosity of others for their continued operation?

If not for the generosity of donors, most colleges and universities would need to severely curtail their course and program offerings, fire faculty and staff, fund less research, and in some cases, close their doors. On the flipside of the coin, however, there is a concern that allowing donors to bring suit will cause any non-profit organization receiving a donation to worry about the donor breathing down its neck in perpetuity. Disallowing standing gives some finality to the gift. Once given, it is given. Permitting donors to have standing after the fact leaves a sort of ambiguity to the gifts and could potentially lead to costly oversight as the donor requests accountings and access to information about the administration of each dollar given.[257]

Additionally, because a gift can be construed as a contract, a savvy donor can easily avoid having to worry about handing the reins of enforcement to the attorney general by simply donating the gift via an instrument that is not a charitable trust. Contract law allows for two parties to bargain around many default rules. If a charitable donation is viewed as a charitable trust by default, one must simply indicate in the gift instrument that the gift is being given under contract. Then, the donor may reserve some interest in the gift so that he or she might be able to enforce it or

256. L.B. Research & Educ. Found. v. UCLA Found., 29 Cal. Rptr. 3d 710 (Cal. Ct. App. 2005); Hardt v. Vitae Foundation, Inc., 302 S.W.3d 133 (Mo. Ct. App. 2010).

257. *See, e.g.*, *L.B. Research*, 29 Cal. Rptr. 3d at 716 (in which the court construes the gift as a contract rather than a charitable trust).

rescind it altogether, should the recipient not administer the gift according to the instrument's terms.

Is it too paternalistic not to leave the issue of donor standing as it is? New legislation, as both Helge and Chester have noted, is politically difficult to pass because no one wants to look like he is increasing regulation among those who are "doing good."[258] Additionally, are scholars focusing on this issue too much in terms of its *ex post* effects? Instead, why not look to all the existing mechanisms that can avoid the issue *ex ante* through good lawyering and careful drafting of the gift instrument? While many gifts are viewed as charitable trusts, they need not always be, especially if the donor and his or her lawyer take affirmative steps to ensure that the gift is viewed as a contract.

Of course, this places a very high burden on the donor to ensure they select the instrument that best effectuates their intent, and might not result in an arm's length transaction because colleges and universities tend to be equipped with a legal department that is familiar with methods of charitable donations. In *Newell,* for example, Elizabeth Banks made a generous donation to Johns Hopkins and thought that the contract she had drafted would protect her family farm from being densely developed, but when her heirs sued the University for pursuing development anyway, the court granted summary judgment to Johns Hopkins.[259]

D. Gift-overs

Even if one were still to make a charitable trust, there are mechanisms that can incentivize the institution to properly allocate the funds. Through a "gift-over," the donor is able to make a gift to Charitable Institution A, which is able to keep the funds so long as they adhere to the terms of the gift instrument.[260] Should they fail to meet these terms, the gift goes to Charitable Institution B.

Gift-overs create many problems—particularly the risk that they might not provide a satisfactory remedy in the event of breach. For example, if a donor intends to make a substantial donation to the University of Blackacre for a specific purpose, he or she would likely prefer a remedy ordering specific performance of the terms of the gift to ensure that Blackacre use the funds as requested, rather than a remedy that would send the funds on to Whiteacre because Whiteacre was not the donor's first choice for the gift. Additionally, a gift-over from one charity to another can be voided "unless it is so limited as to be certain to vest in interest at a period not

258. Helge, *supra* note 59, at 27–31; Chester, *Enforcement Mechanisms*, *supra* note 237, at 468–69.

259. Newell v. Johns Hopkins Univ., 79 A.3d 1009 (Md. Ct. Spec. App. 2013).

260. BOGERT & BOGERT, *supra* note 59, § 415.

more remote than the end of lives in being and twenty-one years."[261] In such an instance where the gift-over is voided, then the funds would remain in the hands of the trustees.[262] A savvy donor could merely contract around the potential voiding of the gift-over by stipulating that a breach of the terms results in the cessation of the trustee's interest in the gift.[263] In spite of this, there are still a lot of gray areas in which a donor may think he or she has provided for every contingency, but end up with a void instrument. Finally, many donors may not contemplate that the charitable institution to which they are giving will not abide by the terms of the gift in the first place.

E. The Doctrine of *Cy Pres*

The doctrine of *cy pres* should also be addressed as an existing remedial mechanism.[264] The Restatement (Third) of Trusts Section 67(a), states in relevant part that:

> Unless the terms of the trust provide otherwise, where property is placed in trust to be applied to a designated charitable purpose and it is or becomes unlawful, impossible, or impracticable to carry out that purpose . . . the charitable trust will not fail but the court will direct application of the property or appropriate portion thereof to a charitable purpose that reasonably approximates the designated purpose.[265]

Comments to Section 67 describe the historical origin of the doctrine from the English common law and the prerogative power exercised by the crown,[266] before turning to the modern rationale of the *cy pres* doctrine in the American system.[267] Where a charitable trust makes provisions that at

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261. *Id.*
262. *Id.*
263. *Id.*
264. *See generally* DUKEMINIER, SITKOFF & LINDGREN, *supra* note 30, at 760–76.
265. RESTATEMENT (THIRD) OF TRUSTS § 67 (2003).
266. *Id*. at § 67, cmt. a.
267. *Id.*

> The cy pres doctrine's modern rationale rests primarily in the perpetual duration allowed charitable trusts and in the resulting risk that designated charitable purposes may become obsolete as the needs and circumstances of society evolve over time, not to mention the sometimes unanticipated extent of decrease or increase in the funds available from a given trust. Nevertheless, the doctrine may also apply to a charitable trust if, at the time of its creation, the particular purpose of the trust has been fully accomplished or cannot possibly or practicably be accomplished. On the other hand, if at the time of the trust's creation its intended purpose is of no value at all to the community, or is otherwise not charitable by its nature, the trust is not enforceable as a charitable trust and is not subject to the rule of this Section.

Id.

the time are ostensibly legal and relevant, there is a risk that over time—especially where a large gift goes into an endowment that could potentially continue into perpetuity—the original purpose of the gift may become illegal or obsolete.[268] The doctrine of *cy pres* depends largely on a judicial interpretation of the donor's original intent, but the determination is often problematic. Section 413 of the UTC reiterates the *cy pres* principle, stating:

> (a) Except as otherwise provided in subsection (b), if a particular charitable purpose becomes unlawful, impracticable, impossible to achieve, or wasteful:
>
> (1) the trust does not fail, in whole or in part;
>
> (2) the trust property does not revert to the settlor or the settlor's successors in interest; and
>
> (3) the court may apply *cy pres* to modify or terminate the trust by directing that the trust property be applied or distributed, in whole or in part, in a manner consistent with the settlor's charitable purposes.[269]

Comment (a) demonstrates the slight change from the Restatement's articulation of the doctrine by presuming that the donor had a general charitable intent rather than the traditional rule, which first inquired as to whether there was an intent before applying the doctrine.[270] *In re Estate of Elkins*[271] provides some insight as to how the doctrine might be applied in awarding the funds to a different charitable institution whose goals are in sync with the donor's intent by looking to factors such as the charity's named purpose, "the locality of the intended charity[,] and the nature of the

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268. *Id.*

269. UNIFORM TRUST CODE § 413 (2000). Exceptions to this rule are provided in UTC § 413(b), which states:

> (b) A provision in the terms of a charitable trust that would result in distribution of the trust property to a noncharitable beneficiary prevails over the power of the court under subsection (a) to apply cy pres to modify or terminate the trust only if, when the provision takes effect:
>
> (1) the trust property is to revert to the settlor and the settlor is still living; or
>
> (2) fewer than 21 years have elapsed since the date of the trust's creation.

Id. at § 413(b).

270. *Id* at § 413, cmt. a. The text states:

> Comment a. . . . modifies the doctrine of cy pres by presuming that the settlor had a general charitable intent when a particular charitable purpose becomes impossible or impracticable to achieve. Traditional doctrine did not supply that presumption, leaving it to the courts to determine whether the settlor had a general charitable intent. If such an intent is found, the trust property is applied to other charitable purposes. If not, the charitable trust fails.

Id.

271. 888 A.2d 815 (Pa. Super. 2005)

population that would be served by the gift."[272] In that case, the court held that the charitable purpose of a testamentary trust to a non-profit hospital failed when the hospital was sold to a for-profit corporation—transforming the institution from simply a hospital to both a hospital and a medical school.[273] Because the purpose had failed, the doctrine of *cy pres* was applied to best effectuate the testator's intent—enabling the trustee to award funds exclusively to the hospital portion of the corporation.[274]

Evelyn Brody describes some downside to the doctrine of *cy pres* in jurisdictions that have not adopted the Uniform Trust Code.[275] At common law, restricted gifts are seen as completed transactions, meaning donors cannot later alter the terms of the gift; thus, a donor could participate in a *cy pres* proceeding only in order to avert a reversionary interest in the property from vesting.[276] Likewise, because the donor's control of the property ends when the trust is created, a court does not have to take the donor's intent into account.[277] Additionally, *cy pres* is a limited remedy in most cases because it depends on the impossibility or impracticability of meeting the terms of the trust.[278] Finally, standing for *cy pres* is limited to trustees—therefore it has many of the same problems with donor standing as restricted gifts.[279]

Freedom of contract enables donors to contract around default rules *ex ante* in such a way as to preserve an interest in the property or to provide conditional provisions. This coupled with the doctrine of *cy pres* acting as an *ex post* remedy, raises the question: Do we really need any further legislation to solve the "problem"? Is there even a "problem" at all? Do the benefits to a limited number of donors who did not take proper precautions when drafting their gift instruments really outweigh the costs to charitable institutions that receive the gifts in question and are then distracted from their charitable mission by costly litigation?

F. Finding a Solution: What is at Stake

If a person wishes to leave funds in trust, he or she creates a trust. If that person intends to make a contract, then he or she makes a contract. Further, if that person wants to give a gift, then he or she may give a gift.

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272. *Id.* at 826 (applying the doctrine of *cy pres* because the charitable purpose of the testamentary trust failed).

273. *Id.* at 824–25.

274. *Id.* at 826.

275. Brody, *Dead Hand*, *supra* note 51.

276. *Id.* at 1238–39.

277. Kilcoyne, *supra* note 93, at 140. Kilcoyne also states that even though this is the case, courts "undoubtedly" will try to take donor intent into account. *Id.*

278. *Id.*

279. *Id.* at 141.

By categorically allowing all donors standing in all of these situations, we would open up the courts and the non-profit sector to an extremely difficult amount of oversight. In the area of colleges and universities, this would be especially problematic when one sees the number of individuals and families who have donated significant amounts of money to a given school. If each and every one of these donors were able to bring suit, it would raise a host of administrative difficulties. Should we really subject colleges and universities to even more scrutiny from "the watchful gaze of the donor"?[280] It is quite possible that a donor, who might otherwise be simply irritated with the administration of certain donated funds, would have the ability to bring some sort of action under this new regime.

On the other hand, if donor standing is denied, many meritorious claims will be dismissed for lack of standing. Again, there is a disparity in bargaining power between a college or university with a knowledgeable general counsel's office that deals with charitable donations on a regular basis and an alumnus who might be making a single donation for a scholarship fund in honor of his parents. Placing the burden of good lawyering on the donor in such cases may be unfair because once the gift is made, the only enforcement mechanism may be by the attorney general, who lacks the time, resources, and personal investment in the donation to bring an enforcement suit. Additionally, failure to recognize donor standing might incentivize a larger category of donors to make restricted gifts through contracts, which could in turn lead to even more scrutiny from the donor.

There needs to be a middle ground. It is best negotiated through broad legislative guidelines that are applied narrowly by the judiciary, analyzing each case on its unique facts, in light of past precedent. Further legislation—if too specific—has the potential to create new loopholes and new confusions that the courts will then have to deal with. The most important thing is that whatever is decided upon be transparent and consistent so that donors know their position when they make a charitable donation.

Ultimately, the question of standing comes down to the donor's intent because without the charitable donation the problem would never exist. If the donor truly intended to make a gift to a non-profit institution, such as a college or university, then we should allow this gift to stand as exactly that—a gift. While many parents would love to admonish their children for using a toy received as a Christmas present in a way other than they would like, the child in the end will be able to do with the gift what they would like. However, this does not mean that a child who uses his new toy truck to terrorize his little sister will not get a time-out or have his truck taken away from him. We should not allow donors to become overbearing

280. Weisbord, *Reservations*, *supra* note 22, at 248–50.

parents, but we should also not allow colleges and universities to become bratty children either.

There is a need for donors to have standing, but this is only in certain, very limited circumstances. The distinct gift instruments utilized indicate the type of donative transfer the donor intended. By examining the form of the gift instrument that the donor utilized, courts can infer the donor's intent at the time that the donor made the gift. Because of the variety of gift instruments available and the unique sets of facts to each donative transfer, the judiciary is better suited than the legislature for reform.

It is undeniable, however, that there is a trend towards increased donor standing. The UTC is a fairly recent document, and in just over a decade, nearly half the states have adopted it.[281] Even in jurisdictions that have not adopted the UTC, judicial precedent in some instances has increased donor standing. While the idea of introducing legislation that goes after those who are "doing good" may be classified as "politically unpopular," there are numerous instances in which such legislation has passed.[282] We should not stop all attempts at legislating the issue, but the broad building blocks are already present for the judiciary to apply.

CONCLUSION

Charitable institutions rely on the generosity of donors in order to fulfill their charitable purposes. Colleges and universities are no exception. Without the support of alumni and other donors, many educational institutions would need to severely curtail their course and program offerings or even shut their doors altogether. Colleges and universities that receive large gifts from donors will continue to depend on such generosity and thus will also continue to be subjected to donor scrutiny in administering these gifts according to their terms.

In part, the issue of donor standing can be solved before the word "litigation" is ever uttered. Through careful drafting of contracts or trust instruments, donors can ensure that, if need be, they will have the ability to sue the school—and if successful in that suit, convince a court to order the school to administer the gift according to its terms. Parties have been and will continue to be able to contract around default rules. By utilizing clear terms and making provisions for gift-overs or reserving an interest in the donor, the standing issue can be completely circumvented without ever having to worry about state statutes or court precedent. Likewise, colleges and universities can take affirmative steps to ensure that they will not be the objects of litigation by ensuring that they can meet the terms of the gift and by understanding in advance what sort of enforcement power the donor

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281. *See* UTC States, *supra* note 206.

282. Chester, *Enforcement Mechanisms*, *supra* note 237, at 468–69.

does or does not have.

Ultimately, the issue of donor standing in enforcing the terms of a charitable donation is a complex problem without an easy answer. Many scholars have proffered methods by which legislatures could bring uniformity to this issue where courts have previously been unsuccessful in doing so. This could create both some uniformity among jurisdictions as well as some certainty for both the donor and the recipient institution in terms of what to expect if the terms of the gift are not met. However, legislative reform is insufficient without judicial reform also. If the trend towards increased donor standing is to continue, it is imperative that it be done not only through legislation but also at the ground level with courts leading the way to a more consistent process. It is the courts who must place a high burden of proof on the donor-plaintiff in order to safeguard colleges and universities from diverting time, energy, and money from their educational purposes. Likewise, it is the courts that must ensure that fairness and justice are promoted by recognizing the disparities in bargaining power that may have existed at the time the donative instrument was drafted.

This Note asks whether increased donor standing will prove harmful or helpful to American colleges and universities; the answer is: a little bit of both. Increased donor standing is harmful in that it may lead to more litigation in instances in which a gift is not being administered according to its restrictions, but this is a double-edged sword that will necessarily increase accountability among boards of trustees. With expanded donor standing, there is an expanded incentive for colleges and universities to act with good faith and loyalty in administering gifts. "Harmful" and "helpful" are relative terms because charitable donations are a two-way street—what the college or university may see as "harmful" may in fact be more fair and just for the donor. At the end of the day, increased donor standing will force both the donor and the donee to carefully and thoughtfully participate in donative transfers that are mutually beneficial.

THE FUTURE OF RACIAL PREFERENCES:

A REVIEW OF RUSSELL K. NIELI'S *WOUNDS THAT WILL NOT HEAL: AFFIRMATIVE ACTION AND OUR CONTINUING RACIAL DIVIDE* & RANDALL KENNEDY'S *FOR DISCRIMINATION: RACE, AFFIRMATIVE ACTION, AND THE LAW*

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INTRODUCTION

"*The way to stop discrimination on the basis of race is to stop discriminating on the basis of race.*" —Chief Justice Roberts[1]

Randall Kennedy disagrees with the Chief Justice; he wants to continue racial discrimination. In a provocative new book, *For Discrimination: Race, Affirmative Action, & The Law,*[2] Kennedy, a professor at Harvard Law School, advocates a continuation and even expansion of racial preferences in college and university admissions. Kennedy readily acknowledges that racial preferences "distinguish between people on a racial basis . . . discriminate . . . redistribute resources . . . favor preferred racial categories of candidates, promoting some racial minorities over whites with superior records . . . [and] generate stigma and resentment."[3] Nevertheless, Kennedy claims that racial preferences are morally required to compensate for past racial discrimination by all aspects of society.[4]

Russell K. Nieli agrees with the Chief Justice; he wants to end racial discrimination. In a 2012 book, *Wounds That Will Not Heal: Affirmative Action and Our Continuing Racial Divide*,[5] Nieli, a lecturer in politics at Princeton University, advocates an immediate end to racial preferences. "Reworking a series of essays compiled over a period of more than three decades, [the book presents] a no-holds-barred critique of race-based employment and university admissions policies, whose consequences for the social harmony and well-being of America, are almost wholly negative."[6] Essentially, Nieli offers a social science argument for the end of racial preferences.

The two books are complementary—both are skeptical of the Supreme Court's diversity rationale for racial preferences.[7] At the same

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1. Parents Involved in Cmty. Sch. v. Seattle Sch. Dist. No. 1, 551 U.S. 701, 748 (2007) (Roberts, C.J., joined by Scalia, Thomas, & Alito, JJ., announcing the judgment of the Court). For a discussion of the higher education implications of the case, see generally Charles J. Russo & William E. Thro, *Higher Education Implications of Parents Involved for Community Schools*, 35 J.C. & U.L. 239 (2009).

2. RANDALL KENNEDY, FOR DISCRIMINATION: RACE, AFFIRMATIVE ACTION, & THE LAW (2013).

3. *Id*. at 18–19.

4. *Id*. at 11.

5. RUSSELL K. NIELI, WOUNDS THAT WILL NOT HEAL: AFFIRMATIVE ACTION AND OUR CONTINUING RACIAL DIVIDE (2012).

6. *Id.* at 10.

7. *See* KENNEDY, *supra* note 2, at 13, 97–103, 202–03; NIELI, *supra* note 5, at 241–75.

time, the books are contradictory—one advocates for the continuation of racial preferences on moral grounds while the other calls for an immediate end to racial preferences on social science grounds. Taken together, the two authors collectively provide a foundation for an intelligent discussion of the wisdom of racial preferences in college and university admissions.

Of course, any discussion of racial preferences in higher education must confront the elephant in the room—the Constitution.[8] While the Court has imposed significant restrictions on the use of race in college and university admissions,[9] *Fisher v. University of Texas* will force many institutions to reconsider their use of racial preferences.[10] After *Fisher*, any use of race is conditioned on the college or university proving that there is no workable race-neutral alternative.[11] Many colleges and universities will not be able to meet that burden. Unless the Court over

8. Although private institutions are not subject to the restrictions of the Constitution, private institutions that receive federal funds must adhere to constitutional standards. In re Civil Rights Cases, 109 U.S. 3 (1883). To explain, all private institutions that receive federal funds are subject to Title VI, which prohibits racial discrimination. 42 U.S.C. § 2000d (2012). The Supreme Court explicitly held "that discrimination that violates the Equal Protection Clause of the Fourteenth Amendment committed by [a private] institution that accepts federal funds also constitutes a violation of Title VI." Gratz v. Bollinger, 539 U.S. 244, 275 n.23 (2003). *See also* Grutter v. Bollinger, 539 U.S. 306, 342 (2003) (holding that because there is no equal protection violation, there is no Title VI violation). Moreover, the nondiscrimination obligation of Title VI applies to "all of the operations" of "a college, university, or other postsecondary institution, or a public system of higher education . . . any part of which receives federal financial assistance." 20 U.S.C. § 2000d-4a (2012). An institution subject to Title VI may not discriminate because of race or gender in financial aid programs "directly or through contractual or other arrangements." 34 C.F.R. § 100.3(b).

9. *See Grutter*, 539 U.S. at 306; *Gratz*, 539 U.S. at 244; Regents of Univ. of Cal. v. Bakke, 438 U.S. 265, 307 (1978).

10. 133 S. Ct. 2411 (2013). As one scholar observed:

> I very much doubt that the way colleges and universities have justified their individual policies in the recent past will continue to work. Many schools have operated under the assumption that they can justify their policy in isolation—that all they need to do is show their application and yield rates and thus prove that without preferences they would have fewer under-represented minorities than they regard as minimally necessary. But it is not just the fact of a race-preferential admissions policy that must be defended now, but also the details of the particular policy and its effects on educational outcomes. Just as different forms of diversity must be balanced against each other, different pedagogical problems must be considered against each other. More specifically, the pedagogical advantages of racial diversity must be balanced against the pedagogical disadvantages of gaps in academic credentials.

Gail Heriot, Fisher v. University of Texas*: The Court (Belatedly) Attempts To Invoke Reason and Principle*, 2012 CATO SUP. CT. REV. 63, 89 (2013).

11. *Fisher*, 133 S. Ct. at 2419–20.

rules or limits *Fisher*, the future of racial preferences is more litigation and more restrictions, if not outright prohibition.

This constitutional reality after *Fisher* provides a lens through which to review both Kennedy's and Nieli's books. A policy and legal argument that ignores constitutional reality has little practical value, even if some find the arguments persuasive. This review of *For Discrimination* and *Wounds That Will Not Heal* has three parts. Part I examines Kennedy's moral argument for continuing racial preferences. Part II explores Nieli's social science argument for ending racial preferences. Part III details the post-*Fisher* constitutional reality—wherein racial preferences still exist, but are limited. This review concludes that unless the Court overrules or limits *Fisher*, neither Kennedy nor Nieli can prevail in total; nevertheless, Nieli's vision will prevail for those institutions that cannot meet the *Fisher* requirements.

I. KENNEDY'S MORAL ARGUMENT FOR RACIAL PREFERENCES

Kennedy's justification for racial preferences is simple:

> I support it because, on balance, it is conducive to the public good. It is a continuation and intensification of an egalitarian and democratic impulse in American race relations that has been gathering momentum, albeit fitfully and with dramatic reversals, since at least the Civil War. Racial affirmative action partially redresses debilitating social wrongs. Racial minorities, and blacks in particular, have long suffered from racist mistreatment at the hands of the federal government, state governments, local governments, and private parties. This oppression has produced a cycle of self-perpetuating problems that will not resolve themselves without interventions that go beyond prospective prohibitions on intentional racial mistreatment. Past wrongs have diminished the educational, financial, and other resources that marginalized groups can call upon, and have thus disadvantaged them in competition with whites. Hence, it is not enough simply to end racist mistreatment. Reasonable efforts to rectify the negative legacy of past wrongs are also morally required.[12]

As Nieli notes, "[w]hile Kennedy is generally supportive of racial-preference policies, he agrees with critics that the diversity rationale is a weak foundation on which to base one's defense of such policies, and is at best a secondary concern of many who support and maintain affirmative action policies for other reasons."[13] Indeed, Kennedy "used to

12. KENNEDY, *supra* note 2, at 11.
13. NIELI, *supra* note 5, at 246.

disdain the diversity rationale, and . . . continue[s] to think that some of the claims made on its behalf are excessive."[14]

Kennedy sets out his moral argument for racial preferences in five chapters. Chapter One explores the history of affirmative action.[15] First, Kennedy examines the National Government's effort to assist the newly freed slaves following the Reconstruction Era.[16] Second, he discusses the early efforts of the national government and some states to outlaw racial discrimination in employment during the 1940s.[17] Third, he explores the developments of anti-discrimination law during the Civil Rights Era.[18] Fourth, Kennedy discusses the late 1960s and early 1970s adoption of the "New Affirmative Action," programs designed to "channel benefits on an expressly racial basis to groups that are deemed in need of special assistance."[19] Fifth, he details the history of the "affirmative action stalemate" since the 1970s, including a comprehensive discussion of Supreme Court decisions.[20] Finally, he examines the efforts to restrict racial preferences through state ballot initiatives.[21]

Chapter Two sets out the pro and con arguments for racial preferences.[22] Kennedy focuses on four possible justifications for racial preferences: (1) reparations;[23] (2) diversity;[24] (3) integration;[25] and (4) supplementing existing anti-discrimination laws.[26] Kennedy makes the arguments for all justifications, details the counterarguments, and responds to the counterarguments. He also addresses the argument that racial preferences actually hurt their intended beneficiaries.[27] Kennedy concludes that "racial affirmative action as typically designed and administered does indeed help racial minorities—those assisted directly and those benefited indirectly—and that it helps America as a whole with its ongoing struggle to redress long-standing injustices and to knit together a deeply divided society."[28]

Chapter Three confronts the "Color Blind Challenge" to racial pref-

14. KENNEDY, *supra* note 2, at 13.
15. *Id.* at 22–77.
16. *Id.* at 22–26.
17. *Id.* at 26–30.
18. *Id.* at 31–38.
19. *Id.* at 39–54.
20. *Id.* at 54–69.
21. *Id.* at 69–77.
22. *Id.* at 78–146.
23. *Id.* at 78–94.
24. *Id.* at 94–106.
25. *Id.* at 106–07.
26. *Id.* at 107–15.
27. *Id.* at 115–34.
28. *Id.* at 78.

erences.[29] First, Kennedy details the history of the notion of a colorblind constitution beginning with Justice Harlan's 1896 dissent in *Plessy v. Ferguson,*[30] and he continues the history through the present day.[31] Second, he details what he regards as the attractions of the colorblind position.[32] Third, he offers a comprehensive analysis of the problems arising out of the colorblind position.[33]

Chapter Four offers a comprehensive history of the Supreme Court's struggles with racial preferences in college and university admissions.[34] Kennedy discusses all three acts: *Bakke*;[35] the University of Michigan cases;[36] and *Fisher*.[37] The *Fisher* discussion was written before the Court rendered its decision and, thus, it does not address the actual opinion.

Chapter Five concludes the book "by offering three observations regarding the future of racial affirmative action in the United States."[38] First, "[r]ace neutral policies that are actually race conscious are simply the latest in a long line of legal fictions in American race relations law."[39] Second, "[t]he United States will have company as it continues fitfully to reform itself racially."[40] Other nations and international treaties appear to both implicitly and explicitly demand racial preferences.[41] Third, because racism is persistent, society should be reluctant to impose an endpoint.[42]

Ultimately, Kennedy's moral argument is unpersuasive. To be sure, African-Americans have been the victims of immoral, unconstitutional, and illegal behavior for centuries. At the same time, however, Kennedy's moral position is undermined by his failure to acknowledge white poverty. Income inequality is growing;[43] the white lower class is in-

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29. *Id.* at 147–81.
30. 163 U.S. 537, 554–59 (1896) (Harlan, J., dissenting).
31. KENNEDY, *supra* note 2, at 148–54.
32. *Id*. at 154–61.
33. *Id*. at 161–81.
34. *Id*. at 182–239.
35. *Id*. at 182–205
36. *Id*. at 205–21.
37. *Id*. at 221–40.
38. *Id*. at 240.
39. *Id.* at 242.
40. *Id*. at 245.
41. *Id*. at 245–53.
42. *Id*. at 253–54.
43. As Sander and Taylor note:

> Since 1979 the share of consumer income in the United States going to the top five percent of the income distribution has doubled, and the share going to the top 0.1 percent has more than tripled. Measures of social mobility show that persons who start life in the bottom fifth of the in

creasingly dysfunctional and self-destructive.[44] For example, Eastern Kentucky, a region that is almost entirely white, is impoverished.[45] Nevertheless, the primary beneficiaries of admissions preferences are middle class minorities.[46] "Rather than being 'visibly open to talented and qualified individuals of every race and ethnicity,' selective colleges can much more accurately be described as bastions of privilege, with no more than a tenth of their enrollments coming from the less fortunate half of American society."[47] If justice requires an admissions preference for the son of African-American lawyers, justice also requires an admissions preference for the coal miner's daughter.

II. NIELI'S SOCIAL SCIENCE ARGUMENT FOR AN END TO RACIAL PREFERENCES

Nieli's justification for ending racial preferences immediately is simple:

> From the very beginning, however, racial preference policy was anathema to large segments of the American public, including many of those who had fought the good fight to end segregation and racial oppression in the Jim Crow South. For them, racial preferences were a shameful betrayal of the highest ideals of the civil rights movement, and of Justice Harlan's magisterial pronouncement in the *Plessy* case that 'our Constitution is color-blind and neither knows nor tolerates

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> come distribution are less likely now than they were a generation ago to move to the top half.

RICHARD SANDER & STUART TAYLOR, JR., MISMATCH: HOW AFFIRMATIVE ACTION HURTS STUDENTS IT'S INTENDED TO HELP, AND WHY UNIVERSITIES WON'T ADMIT IT 248 (2012).

44. *See* CHARLES MURRAY, COMING APART: THE STATE OF WHITE AMERICA 1960-2010 (2012).

45. Kevin D. Williamson, *Left Behind: An Elegy for Appalachia*, NAT'L REV., Dec. 16, 2013, at 28. Unfortunately, the total poverty of Appalachia is not new. *See* HENRY M. CAUDILL, NIGHT COMES TO THE CUMBERLANDS: A BIOGRAPHY OF A DEPRESSED AREA (1963).

46. While racial preferences increase the number of minorities on campus, they do little to increase the number of poor minorities on campus. As Sander and Taylor explain:

> In an authoritative series of national surveys of high school students, more than half of blacks entering elite colleges in 1972 came from families that were in the bottom half of the socioeconomic distribution. By 1982 less than a quarter of blacks entering elite colleges came from the bottom half, and by 1992 the proportion was down to eight percent. Two-thirds of the 1992 cohort of blacks at elite colleges came from the top quartile of the American socioeconomic distribution—that is, the upper-middle class and the upper class. There is little reason to think that things have gotten better since then.

SANDER & TAYLOR, *supra* note 43, at 248.

47. PETER G. SCHMIDT, COLOR AND MONEY: HOW RICH WHITE KIDS ARE WINNING THE WAR OVER COLLEGE AFFIRMATIVE ACTION 3 (2007).

> classes among citizens.'[48]

Nieli concluded that, "[u]ntil they are removed, racial preferences . . . will continue to gnaw at the interethnic norm of reciprocity and fairness, which is the very linchpin holding together racially and ethnically diverse societies like the United States."[49]

Nieli's book is an exhaustive and comprehensive review of the social science data surrounding racial preferences, but he intends it "more as an exercise in social policy criticism than a new addition to social research more narrowly conceived."[50] The book has three main goals. First:

> [I]t seeks to explain the continuing sense of outrage and betrayal that is felt by so many Americans—especially Asians, poor whites, and those 'white ethnics' whose forebears often immigrated to the U.S. from many of the poorest regions of Southern and Eastern Europe—over policies of ethno-racial preferences from which their own kind have been systematically excluded.[51]

Second, the book aims:

> [T]o direct attention to some of the most revealing social science research over the past 15 years that critically evaluates the claims of racial preference supporters. Much of this research is addressed to refuting the contentions of the three pro-affirmative action River Books sponsored by the Andrew W. Mellon Foundation.[52]

In particular, Nieli seeks to use "contemporary evolutionary biology and evolutionary psychology to explain why policies of racial preferences have so often reduced social harmony, intensified ethno-racial tensions, and ended in violence and murderous rage in the many countries where they have been introduced."[53] Finally, Nieli attempts "to draw attention to what [he has] called . . . the 'second wound that will not heal'—the problem of the inner-city black underclass."[54]

Nieli accomplishes these three goals in six chapters. Chapter One focuses on "the dramatic shift that took place in the early 1970s away from the civil rights era vision of a color-blind society to color-conscious 'quota' thinking and other group-based understandings of

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48. NIELI, *supra* note 5, at 10.
49. *Id.*
50. *Id.* at 18.
51. *Id.* at 20.
52. *Id.* at 21.
53. *Id.*
54. *Id.* at 24.

human rights and government entitlements."[55] In particular, Nieli discusses the distinction between tribalism and personalism. Tribalism regards individuals as part of a larger group; what matters is whether the individual possesses the characteristics of the group.[56] In contrast, personalism focuses on the talents and character of the individual.[57] As Nieli demonstrates, the effect of America's embrace of racial preferences is the adoption of the "tribalistic consciousness" and an abandonment of the personalism philosophy that underlies traditional anti-discrimination legislation.[58]

Chapter Two addresses "the claim that racial preference policies serve to combat the racist understanding that certain types of jobs are mainly for whites and not suitable for black capacities or interests."[59] Nieli demonstrates that "racial-preference policies serve to heighten rather than reduce racist ideas and racist understandings."[60] Drawing on the work of labor economists, Nieli shows that racial preferences have not had a significant impact in reducing income disparities between races.[61] Emphasizing the work of Michael Walzer,[62] Nieli concludes that efforts to remedy past discrimination must build upon, rather than undermine, "the understandings of social justice that are widely shared by members of all races in America."[63]

Chapter Three shifts from employment to college and university admissions.[64] In *The Shape of River*, Derek Bok and William Bowen argue that racial preferences have substantial benefits to colleges and universities and very few downsides.[65] Nieli disputes their conclusion and contends that there is "a huge downside to preference policies both at the undergraduate and professional-school levels."[66] Specifically, Nieli shows downsides such as the following: deep resentment of

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55. *Id*. at 31. As Nieli explains, this chapter is a revised version of the fourth chapter in his anthology, RACIAL PREFERENCE AND RACIAL JUSTICE—THE NEW AFFIRMATIVE ACTION CONTROVERSY (1991).

56. *Id*. at 37–38.

57. *Id*. at 39–43.

58. *Id*. at 37–39.

59. *Id.* at 97. Chapter 2 is adapted from Nieli's comments to Andrew Koppelman on the first draft of Koppelman's ANTI-DISCRIMINATION LAW & SOCIAL EQUALITY (2001).

60. *Id.* at 98; 99–127.

61. *Id*. at 127–31.

62. *Id*. at 131. Nieli explicitly references Michael Walzer's, SPHERES OF JUSTICE (1984).

63. *Id*. at 98–99.

64. This Chapter originally appeared in the Fall 2004 issue of *Academic Questions.*

65. DEREK BOK & WILLIAM BOWEN, THE SHAPE OF THE RIVER (1998).

66. NIELI, *supra* note 5, at 134.

preferences among whites and Asians;[67] lower academic performance among minorities who are admitted under racial preferences;[68] little impact on future earnings of minorities who benefit from preferences;[69] increased self-segregation by race on campuses;[70] no real economic benefits to whites and Asians that attend racially diverse institutions;[71] and, in the context of law schools, higher dropout and bar failure rates.[72] Although these negative consequences would normally cause rational policy makers to abandon such policies, Nieli, building upon the work of Shelby Steele,[73] offers "white guilt" as an explanation for the continuation of racial preferences.[74]

In Chapter Four,[75] Nieli shows that racial ethnic diversity leads to uncertain outcomes. In short, it all depends upon the circumstances.[76] As Nieli explains, advocates of the "contact hypothesis" believe increased interaction between people of different racial and ethnic groups leads to less prejudice, greater understanding and empathy, and more societal harmony.[77] However, recent research suggests that increased contact among different racial groups actually promotes discord and conflict.[78] Utilizing the work of Robert Putnam,[79] Nieli sets out a "revised contact hypothesis" where benefits result only under unique and limited circumstances.[80] Concluding the chapter, Nieli explains how mismatching—the process where minority students attend more selective institutions than they would attend without racial preferences—actually undermines the value of diversity.[81]

In Chapter Five,[82] Nieli turns to a critique of the sequels to *The Shape of the River*.[83] Nieli argues that these subsequent books fail to compre-

67. *Id.* at 172–79.
68. *Id.* at 163–72.
69. *Id.* at 143–48.
70. *Id.* at 186–87.
71. *Id.* at 215–22.
72. *Id.* at 222–32.
73. *See* SHELBY STEELE, A DREAM DEFERRED (1998); SHELBY STEELE, SECOND THOUGHTS ABOUT RACE IN AMERICA (2001).
74. NIELI, *supra* note 5, at 235–40.
75. Chapter IV originally appeared as *Diversity's Discontents: The Contact Hypothesis Exploded,* 21 ACAD. QUESTIONS 409 (2008).
76. NIELI*, supra* note 5, at 241.
77. *Id.* at 247–50.
78. *Id.* at 250–53.
79. ROBERT PUTNAM, BOWLING ALONE (2001).
80. Nieli, *supra* note 5, at 253–71.
81. *Id.* at 271–74.
82. This chapter is drawn from a 2004 report for the the National Association of Scholars. *See* RUSSELL K. NIELI, NAS REPORT, THE CHANGING SHAPE OF THE RIVER: AFFIRMATIVE ACTION AND RECENT SOCIAL SCIENCE RESEARCH (2004).
83. *See* DOUGLAS MASSEY, CAMILLE CHARLES, GARVEY LUNDY, & MARY FISCHER, THE

hend the intensity of opposition to racial preferences,[84] misunderstand the disincentives that racial preferences give to minorities,[85] ignore the dysfunctional characteristics of certain subcultures,[86] and do not grasp the impact of racial preferences on middle class minorities.[87] Drawing upon evolutionary psychology and evolutionary sociology, Nieli asserts that racial differences are more volatile than other differences among humans.[88]

In Chapter Six,[89] Nieli departs from the racial preferences theme and focuses exclusively on the problems of the African-American urban poor—the group whose plight first prompted the use of racial preferences in college and university admissions.[90] Drawing heavily on the works of Daniel Patrick Monihyan,[91] William Julius Wilson,[92] Christopher Jencks,[93] and Charles Murray,[94] Nieli traces the problems of the African-American urban poor to the post-World War II migrations from the rural South to the urban areas of the North and Midwest.[95] Yet, asserting that the descendants of slaves who sought to escape the oppression of Jim Crow were ill-equipped to deal with the realities of urban life does not fully explain the continued problem of urban poverty. Recognizing this inadequacy, Nieli takes up "the problem of second-generation maladaptation and delinquency."[96] In doing so, Nieli demonstrates that the problems of the African-American urban poor cannot be solved through admissions or hiring preferences that primarily benefit the middle class; rather there must be a reconstruction of the two-parent family and related community structures.[97]

Ultimately, Nieli makes a persuasive social science argument about

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SOURCE OF THE RIVER: THE SOCIAL ORIGINS OF FRESHMEN AT AMERICA'S SELECTIVE COLLEGES AND UNIVERSITIES (2003); CAMILLE CHARLES, MARY FISCHER, MARGARITA MOONEY, & DOUGLAS MASSEY, TAMING THE RIVER: NEGOTIATING THE ACADEMIC, FINANCIAL, AND SOCIAL CURRENTS IN SELECTIVE COLLEGES AND UNIVERSITIES (2009).

84. NIELI, *supra* note 5, at 284–96.

85. *Id*. at 296–329.

86. *Id.* at 329–46.

87. *Id*. at 346–56.

88. *Id*. at 356–81.

89. This chapter is derived from Russell K. Nieli, *The Disintegration of the Black Lower Class Family*, 22 POL. SCI. REV. 44 (1991).

90. *See* NIELI, *supra* note 5, at 9–10.

91. DANIEL PATRICK MOYNIHAN, FAMILY AND NATION (1986); DANIEL PATRICK MOYNIHAN, THE NEGRO FAMILY: THE CASE FOR NATIONAL ACTION (1965).

92. WILLIAM JULIUS WILSON, THE TRULY DISADVANTAGED (1987).

93. Christopher Jencks, *Review of the Truly Disadvantaged*, NEW REPUBLIC, Jan. 13, 1988 at 28–30.

94. CHARLES MURRAY, LOSING GROUND: AMERICAN SOCIAL POLICY 1950–80 (1984)

95. NIELI, *supra* note 5, at 386–445.

96. *Id.* at 445–80.

97. *Id.* at 480.

racial preferences in college and university admissions—at least as institutions currently use racial preferences. His critique of *The Shape of The River* and its sequels is simply devastating.[98] Those who rely on social science to justify colleges' and universities' current use of racial preferences must confront and refute Nieli's argument to the contrary. His discussion of the pathological dysfunction of urban African-Americans is a provocative addition to the literature.[99]

III. THE CONSTITUTIONAL REALITY—LIMITING, BUT NOT ENDING, RACIAL PREFERENCES

A. Racial Preferences After *Fisher*

The constitutional analysis begins with the propositions that the Equal Protection Clause is "essentially a direction that all persons similarly situated . . . be treated alike,"[100] and that the Constitution protects "*persons*, not *groups*."[101] Indeed, the "rights created by the first section of the Fourteenth Amendment are, by its terms, guaranteed to the individual. The rights established are personal rights."[102] "The guarantee of equal protection cannot mean one thing when applied to one individual and something else when applied to a person of another color. If both are not accorded the same protection, then it is not equal."[103]

Because such distinctions "are by their very nature odious to a free people whose institutions are founded upon the doctrine of equality,"[104] and those distinctions "are contrary to our traditions and hence constitutionally suspect,"[105] "[r]acial and ethnic distinctions of any sort are inherently suspect and thus call for the most exacting judicial examination."[106] Recognizing that "racial characteristics so seldom pro-

98. *Id*. at 133–240, 275–382.

99. *Id.* at 383–480.

100. City of Cleburne v. Cleburne Living Ctr., 473 U.S. 432, 439 (1985); *see also* U.S. CONST. amend. XIV, § 1.

101. Adarand Constructors, Inc. v. Peña, 515 U.S. 200, 227 (1995) (emphasis in original). *See* City of Richmond v. J.A. Croson Co., 488 U.S. 469, 494 (1989); Wygant v. Jackson Bd. of Educ., 476 U.S. 267, 279–80 (1986).

102. Shelley v. Kraemer, 334 U.S. 1, 22 (1948).

103. Regents of Univ. of Cal. v. Bakke, 438 U.S. 265, 289–290 (1978).

104. Shaw v. Reno, 509 U.S. 630, 643 (1993) (quoting Hirabayashi v. United States, 320 U.S. 81, 100 (1943)). *Cf.* United Jewish Orgs. of Williamsburg, Inc. v. Carey, 430 U.S. 144, 173 (1977) (Brennan, J., concurring) ("[A]n explicit policy of assignment by race may serve to stimulate our society's latent race-consciousness."); Wright v. Rockefeller, 376 U.S. 52, 66 (1964) (Douglas, J., dissenting) ("Here the individual is important, not his race, his creed, or his color.").

105. Bolling v. Sharpe, 347 U.S. 497, 499 (1954).

106. *Bakke*, 438 U.S. at 265. *See also Adarand*, 505 U.S. at 227 (holding that "all racial classifications, imposed by whatever federal, state, or local governmental actor, must be analyzed by a reviewing court under strict scrutiny"); *J.A. Croson*

vide a relevant basis for disparate treatment,"[107] racial classifications "are constitutional only if they are narrowly tailored to further compelling governmental interests."[108] "Absent searching judicial inquiry into the justification for such race-based measures, we have no way to determine what 'classifications' are 'benign' or 'remedial' and what classifications are in fact motivated by illegitimate notions of racial inferiority or simple racial politics."[109]

Moreover, the fact that the government might use racial classifications to *help* racial minorities does not change the analysis.[110] Indeed, the Court has "insisted on strict scrutiny in every context, even for so-called 'benign' racial classifications, such as race-conscious university admissions policies, race-based preferences in government contracts, and race-based districting intended to improve minority representation."[111] "The higher education dynamic does not change the narrow tailoring analysis of strict scrutiny applicable in other contexts."[112]

A college or university that wishes to use racial preferences faces a difficult constitutional reality. This reality demands that: (1) the insti

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Co., 488 U.S. at 500–01; Loving v. Virginia*,* 388 U.S. 1, 11 (1967) (quoting Korematsu v. United States, 323 U.S. 214, 216 (1944) ("[T]he Equal Protection Clause demands that racial classifications... be subjected to the 'most rigid scrutiny.'").

107. *J.A. Croson Co.,* 488 U.S. at 505 (quoting Fullilove v. Klutznick*,* 448 U.S. 448, 533–534 (1980) (Stevens, J., dissenting)).

108. Grutter v. Bollinger*,* 539 U.S. 306, 326 (2003). *See also J.A. Croson Co.*, 488 U.S. at 493.

109. *Grutter*, 539 U.S. at 326.

110. "[T]he analysis and level of scrutiny applied to determine the validity of [a racial] classification do not vary simply because the objective appears acceptable.... While the validity and importance of the objective may affect the outcome of the analysis, the analysis itself does not change." Miss. Univ. for Women v. Hogan*,* 458 U.S. 718, 724 n.9 (1982).

111. Johnson v. California, 543 U.S. 499, 505 (2005). *See also Adarand*, 515 U.S. at 226 (stating "despite the surface appeal of holding 'benign' racial classifications to a lower standard, because 'it may not always be clear that a so-called preference is in fact benign . . . .'"); *J.A. Croson Co.*, 488 U.S. at 500 ("But the mere recitation of a 'benign' or legitimate purpose for a racial classification is entitled to little or no weight. Racial classifications are suspect, and that means that simple legislative assurances of good intention cannot suffice."). As Justice Thomas observed:

> That these programs may be motivated, in part, by good intentions cannot provide refuge from the principle that under our Constitution, the government may not make distinctions on the basis of race. As far as the Constitution is concerned, it is irrelevant whether a government's racial classifications are drawn by those who wish to oppress a race or by those who have a sincere desire to help those thought to be disadvantaged. There can be no doubt that the paternalism that appears to lie at the heart of this program is at war with the principle of inherent equality that underlies and infuses our Constitution.

Adarand, 505 U.S. at 240 (Thomas, J., concurring).

112. Fisher v. Univ. of Texas at Austin, 133 S. Ct. 2411, 2421 (2013).

tution prove that its use of race complies with the Constitution; (2) race be used only in extraordinary circumstances; and (3) race be used only as a last resort. Each of these aspects of the constitutional reality warrants additional discussion.

1. The Institution Must Prove Its Use of Race Is Constitutional

Normally, the courts presume that governmental action is constitutional.[113] The private party, as one challenging the constitutionality of the government's action, has the burden of proof "to negate every conceivable basis which might support it."[114]

When government uses racial classification, those presumptions are flipped. "[T]he government has the burden of proving that racial classifications 'are narrowly tailored measures that further compelling governmental interests.'"[115] In the context of racial preferences in higher education, "[s]trict scrutiny requires the university to demonstrate with clarity that its 'purpose or interest is both constitutionally permissible and substantial, and that its use of the classification is necessary . . . to the accomplishment of its purpose.'"[116] Moreover,

> [T]he mere recitation of a "benign" or legitimate purpose for a racial classification is entitled to little or no weight. Strict scrutiny does not permit a court to accept a college or university's assertion that its admissions process uses race in a permissible way without a court giving close analysis to the evidence of how the process works in practice.[117]

2. Race Is Limited to Extraordinary Circumstances

The government's use of race is limited to extraordinary circumstances. The Supreme Court has recognized only two objectives as constitutionally sufficient justifications for race-conscious decision-making: (1) remedying the present effects of identified past intentional discrimination by a particular governmental unit; and (2) obtaining the educational benefits of a diverse student body in higher education.[118] Just as

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113. Lyng v. Automobile Workers, 485 U.S. 360, 370 (1988).

114. F.C.C. v. Beach Comm'ns, Inc., 508 U.S. 307, 314–15 (1993) (quoting Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356, 364 (1973)).

115. *Johnson*, 543 U.S. at 505 (quoting *Adarand,* 515 U.S. at 227).

116. *Fisher,* 133 S. Ct. at 2418 (quoting Regents of Univ. of Cal. v. Bakke, 438 U.S. 265, 305 (1978)).

117. *Fisher*, 133 S. Ct. at 2421 (quoting City of Richmond v. J.A. Croson Co., 488 U.S. 469, 500 (1989)).

118. *See, e.g.,* Grutter v. Bollinger, 539 U.S. 306, 328–30 (2003).; *J.A. Croson Co.*, 488 U.S. at 504–05.

significantly, the Court has rejected, as a matter of constitutional law, a number of other justifications offered by state and local governments for race-conscious measures: remedying societal discrimination; maintaining racial balance; and providing faculty role models for students.[119]

Because most colleges and universities never engaged in past intentional discrimination or, if there was discrimination, have eliminated any present day effects, institutions that wish to use race must rely on the compelling interest of diversity. Despite what many administrators may think, the Court's embrace of "diversity" is:

> [N]ot an interest in simple ethnic diversity, in which a specified percentage of the student body is in effect guaranteed to be members of selected ethnic groups, with the remaining percentage an undifferentiated aggregation of students. The diversity that furthers a compelling state interest encompasses a far broader array of qualifications and characteristics of which racial or ethnic origin is but a single though important element.[120]

A college or university "is not permitted to define diversity as 'some specified percentage of a particular group merely because of its race or ethnic origin.'"[121] "That would amount to outright racial balancing, which is patently unconstitutional."[122] "Racial balancing is not transformed from 'patently unconstitutional' to a compelling state interest simply by relabeling it 'racial diversity.'"[123]

Even when a college or university utilizes this broad definition of diversity, it still "must prove that the means chosen by the University to attain diversity are narrowly tailored to that goal. On this point, the University receives no deference."[124] "It remains at all times the University's obligation to demonstrate, and the Judiciary's obligation to determine, that admissions processes 'ensure that each applicant is evaluated as an individual and not in a way that makes an applicant's race or ethnicity the defining feature of his or her application.'"[125]

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119. *See Grutter,* 539 U.S. at 323–24; Wygant v. Jackson Bd. of Educ., 476 U.S. 267 (1986) (plurality); *Bakke*, 438 U.S. at 307–10. The Court also disapproved the rationale of increasing the number of physicians practicing in under-served areas where the institution did not prove that race-conscious admissions would "promote better health-care delivery to deprived citizens." *Bakke*, 438 U.S. at 310–11.

120. *Bakke,* 438 U.S. at 315.

121. *Fisher*, 131 S. Ct. at 2419 (quoting *Bakke,* 438 U.S. at 307).

122. *Grutter,* 539 U.S. at 330.

123. Parents Involved in Cmty. Sch. v. Seattle Sch. Dist. No. 1, 551 U.S. 701, 732 (2007).

124. *Fisher*, 133 S. Ct. at 2419–20.

125. *Id.* at 2420 (quoting *Grutter*, 539 U.S. at 337).

3. Race Must Be A Last Resort

Consideration of race must be a last resort. Courts must inquire "into whether a university could achieve sufficient diversity without using racial classifications."[126] Put another way, the college or university must prove there are "no workable race-neutral alternatives that would produce the educational benefits of diversity."[127] If there is a workable race-neutral alternative, "then the University may not consider race."[128]

The requirement to prove a negative—that no race-neutral alternative would produce the desired level of minority representation—raises significant problems for colleges and universities. Quite simply, one cannot determine the viability of a race-neutral alternative without first making assumptions about what level of minority representation is sufficient. It is not enough to ascertain that a race-neutral alternative will yield a minority representation of X percent; one must know whether X percent is a "critical mass." If so, then the race-neutral alternative is viable and the college or university may not use race; if not, then the race-neutral alternative is not workable and the institution may use race.

Consequently, the college or university's definition of critical mass effectively is determinative. While the institution is entitled to deference on whether it needs to pursue diversity, it is not entitled to deference on what constitutes a critical mass. Otherwise, a college or university could simply define critical mass in such a way as to always justify the use of race. For example, if a college or university said that it wanted minority representation of ninety percent, it would render all possible race-neutral alternatives unworkable.

Although the Court has not provided guidance on what constitutes a critical mass, and while that definition may well depend upon context, certain parameters seem inherent in any definition of critical mass. Just as it is "completely unrealistic" to assume "that minorities will choose a particular trade in lockstep proportion to their representation in the local population,"[129] it is completely unrealistic to assume that minority representation on a particular campus will exceed their representation in the area served by the college or university. Thus, if a public college or university serves a state or a particular region of a state, the level of minority representation in that state or region provides some rough guidance as to the definition of critical mass. For those public institutions that serve states or regions with low minority

126. *Fisher*, 133 S. Ct. at 2420.
127. *Id*.
128. *Id.*
129. City of Richmond v. J.A. Croson Co., 488 U.S. 469, 507 (1989).

populations, it will be difficult to define critical mass as a high number of minorities.

Once critical mass is defined in a constitutional manner, then the institution must demonstrate that there is no realistic race-neutral alternative that can achieve the critical mass. Such a showing will often be difficult.[130] It involves an analysis of the impact of automatically admitting the top students at every high school in a state or region. In areas where many high schools are not integrated, such a plan can yield a significant amount of minority representation.[131] Colleges and universities must also examine socioeconomic preferences.[132] If minorities

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130. As Heriot explained:

> The bottom line, however, is that if capturing the educational benefits of diversity is the goal, the academic judgments that must be made in fashioning an actual policy are numerous and never-ending. Those judgments cannot be simple-minded sentimental ones and they definitely cannot be political in nature. Reason and principle must prevail.
>
> If *Fisher* does nothing else, it should force colleges and universities to confront the research on mismatch in a detached and scientific manner. That means using ideologically diverse teams of qualified, independent investigators—persons whose job and prestige are not dependent on maintaining the status quo. It means adequately funding and supporting the investigation with access to data. It means following standard scientific procedures by making the data available to qualified researchers who wish to critique the work.

Heriot, *supra* note 10, at 90 (footnotes omitted).

131. In detailing the effects of such a plan at the University of Texas, the Supreme Court observed:

> The University's revised admissions process, coupled with the operation of the Top Ten Percent Law, resulted in a more racially diverse environment at the University. Before the admissions program at issue in this case, in the last year under the post-*Hopwood* AI/PAI system that did not consider race, the entering class was 4.5% African–American and 16.9% Hispanic. This is in contrast with the 1996 pre-*Hopwood* and Top Ten Percent regime, when race was explicitly considered, and the University's entering freshman class was 4.1% African–American and 14.5% Hispanic.

Fisher, 133 S. Ct. at 2416.

132. To explain further:

> Class-based affirmative action comes under a variety of names. It is alternately referred to as "economic" or "socioeconomic" affirmative action, and in some cases loosely characterized as admissions preferences for the poor. Class-based policies are designed to place a "thumb on the scale" for applicants who have faced obstacles to upward mobility. Because demographic factors can present substantial obstacles to upward mobility, supporters of class-conscious affirmative action support this boost as a means to level the playing field. Socioeconomic status exerts a powerful influence on one's likelihood of attending a four-year college. This is especially true when students live in neighborhoods and attend schools where disadvantage is concentrated. Moreover, socioeconomic status significantly impacts the academic measures (e.g., high school

are a disproportionate share of the poor in the area served by the college or university, then a socioeconomic preference has the potential to increase minority representation.[133] A similar logic applies to first generation students—applicants who will be the first in their families to attend college. Additionally, colleges and universities must explore other creative race-neutral measures—such as quotas by region of the State—that might lead to increased minority representation.

For many colleges and universities, there will be workable race-neutral alternatives. If so, then the institution must cease using race and start using the race-neutral alternatives.[134] In other words, racial preferences will end at those schools. Conversely, there will be some institutions where there are no workable race-neutral preferences. This likely will be the case if the minority population is relatively low, if the high schools where minorities attend are generally integrated, and if whites make up a significant portion of the poor and/or the first generation applicants. Those colleges and universities will be allowed to pursue racial preferences, albeit subject to the significant limitations imposed by the court.

B. The Constitutional Reality Prohibits Kennedy's Moral Vision

Randall Kennedy wants to have racial preference as means of righting historical, societal wrongs.[135] Although Kennedy's argument is provocative and interesting, it is incompatible with our constitutional reality for two reasons.

First, he grounds his justification for racial preferences not in obtaining the educational benefits of diversity, but in compensating racial minorities for past societal wrongs. Yet, as Kennedy explicitly acknowledges,[136] remedying societal discrimination is not and never

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> GPAs and standardized test scores) admissions officers use to gauge applicants' college readiness.

Matthew Gaetner & Melissa Hart, *Considering Class: College Access and Diversity*, 7 HARV. L. & POL'Y REV. 367 (2013).

133. Indeed, high achieving low-income students of all races are unlikely to apply to selective institutions. *See* Caroline M. Hoxby & Christopher Avery, *The Missing One-Offs: The Hidden Supply of High Achieving Low-Income Students* (Nat'l Bureau of Econ. Res., Working Paper No. 18586, 2012), *available at* http://www.nber.org /papers/w18586.pdf?new_window=1.

134. Although university administrators may well be alarmed at the end of racial preferences, such a development need not lead to a dramatic decline in minority representation. Indeed, after California banned racial preferences through a state constitutional amendment, the University of California had an increase in both the number of minority applicants and number of minorities actually attending. SANDER & TAYLOR, *supra* note 43, at 138–139.

135. KENNEDY, *supra* note 2, at 11.

136. *Id.* at 194, 199.

has been a compelling governmental interest.[137] As the Court explained:

> '[S]ocietal discrimination' does not justify a classification that imposes disadvantages upon persons like respondent, who bear no responsibility for whatever harm the beneficiaries of the special admissions program are thought to have suffered. To hold otherwise would be to convert a remedy heretofore reserved for violations of legal rights into a privilege that all institutions throughout the Nation could grant at their pleasure to whatever groups are perceived as victims of societal discrimination. That is a step we have never approved.[138]

Similarly, the Court has rejected the notion—implicit in Kennedy's thesis—that increasing the representation of minorities is a compelling governmental interest.[139] "Preferring members of any one group for no reason other than race or ethnic origin is discrimination for its own sake. This the Constitution forbids."[140]

Second, even if Kennedy tied his argument to obtaining the educational benefits of diversity, it is likely that his chosen means is unconstitutional. Kennedy claims to "champion sensibly designed racial affirmative action," but he never defines what he means.[141] Since he states that he benefited from "sensibly designed affirmative action,"[142] one assumes that he regards the preferences that he received as constitutionally appropriate. Thus, one can infer that, in Kennedy's definition of "sensibly designed affirmative action," colleges and universities will favor an African-American from a prestigious prep school over a coal miner's daughter from an abysmal school district in Appalachia.[143] The African-American son of college-educated parents will be preferred over the first generation white student.[144] Law schools will prefer an African-American applicant with an extraordinarily low LSAT score to a white applicant with a high LSAT score.[145] The African-American Ivy League graduate will be preferred over the white graduate of a regional state college or university.[146] Kennedy likely regards these examples as appropriate; the courts likely would find them un-

137. Grutter v. Bollinger, 539 U.S. 306, 323–24 (2003); Regents of Univ. of Cal. v. Bakke, 438 U.S. 265, 306–310 (1978).
138. *Bakke*, 438 U.S. at 310.
139. *Grutter*, 539 U.S. at 323–24; *Bakke*, 438 U.S. at 306–10.
140. *Bakke*, 438 U.S. at 307.
141. KENNEDY, *supra* note 2, at 11.
142. *Id*.
143. *Id.* at 5.
144. *Id.* at 3–4.
145. *Id.* at 5–6.
146. *Id.* at 5.

constitutional.[147]

To be sure, there is always a possibility that the Supreme Court will overrule *Bakke* and *Grutter* and declare that societal discrimination and/or obtaining a particular level of minority representation is a compelling interest. There is also a possibility that the strict scrutiny standard will be lessened for classifications designed to help minorities. Justice Ginsburg has suggested that the government "may properly distinguish between policies of exclusion and inclusion. Actions designed to burden groups long denied full citizenship stature are not sensibly ranked with measures taken to hasten the day when entrenched discrimination and its aftereffects have been extirpated."[148] Yet, in the absence of such a broad change, Kennedy's moral vision is doomed.

C. *Fisher* Will Lead to a Partial Fulfillment of Nieli's Colorblind Admissions Vision

Russell K. Nieli wants to end racial preferences immediately; he wants a colorblind admissions system. As a constitutional matter, his vision is incompatible with current doctrine—the Court is not going to abandon the educational benefits of diversity as a compelling governmental interest. As a practical matter, it seems likely that *Fisher* will force many schools to adopt his vision.

From a constitutional perspective, Nieli's argument depends upon the Court reversing *Grutter* and holding that obtaining the educational benefits of diversity is not a compelling governmental interest. Such a result would remove the only justification for most colleges and universities to use race. Although four Justices—Roberts, Scalia, Thomas, and Alito—have expressed, at least implicitly, their disapproval of diversity as a compelling governmental interest,[149] Justice Kennedy has embraced the diversity rationale.[150] Absent a change in the Court, it seems highly unlikely that the Court will overrule *Grutter*'s diversity rationale.

On a practical level, however, the prospects for Nieli's vision are much better. As noted above, colleges and universities that wish to use

147. *See* Gratz v. Bollinger, 539 U.S. 244, 270 (2003) (finding that "the University's policy, which automatically distributes 20 points, or one-fifth of the points needed to guarantee admission, to every single 'underrepresented minority' applicant solely because of race, is not narrowly tailored to achieve the interest in educational diversity that respondents claim justifies their program").

148. *Gratz*, 539 U.S. at 301 (Ginsburg, J., joined by Souter, J., dissenting).

149. *See* Parents Involved in Cmty. Sch. v. Seattle Sch. Dist. No. 1, 551 U.S. 701, 725–33 (2007); Grutter v. Bollinger, 539 U.S. 306, 346–48 (2003) (Scalia, J., dissenting); *Grutter*, 539 U.S. at 352–54 (Thomas, J., joined by Scalia, J., dissenting).

150. *See Grutter*, 539 U.S. at 387 (Kennedy, J., dissenting).

race must prove a negative, that there is no racial alternative that will result in the necessary critical mass of diversity. Regardless of how a college or university defines critical mass, institutions will find the task of proving that there is no workable race-neutral alternative to be challenging. In those states where the state constitution bans consideration of race, public institutions have found race-neutral ways to promote minority representation.[151] Similarly, studies both at the University of Colorado and the University of North Carolina found that race-neutral mechanisms could produce similar levels of minority students.[152] Given these experiences and social science studies, it seems likely that many other colleges and universities will be unable to prove the negative—that there is no workable race-neutral alternative. Since the existence of a workable race-neutral alternative precludes the use of race, *Fisher* will force many institutions to abandon racial preferences. For those universities, Nieli's vision of a colorblind admissions system will become reality.

CONCLUSION

In the second decade of the twenty-first century, the future of racial preferences is uncertain. Kennedy and Nieli have given us two fascinating and provocative views of why racial preferences should be continued or abolished, respectively. However, it is the Constitution—or more precisely the Supreme Court's interpretation of the Constitution—that will determine the future of racial preferences. Unless the Court overrules or limits *Fisher,* neither Kennedy's moral argument nor Nieli's social science argument will become the constitutional reality; the practical result is that *Fisher* will force many colleges and universities to adopt Nieli's view.

151. *See* SANDER & TAYLOR, *supra* note 43.

152. *See* Brief of the Univ. of N.C. as Amicus Curiae Supporting Respondents, at 33–34, Fisher v. Univ. of Tex., 133 S. Ct. 2411 (2013) (No. 11-345) (explaining that if the University of North Carolina adopted a top ten percent plan, minority representation would actually increase; test scores would decline). *See generally* Gaetner & Hart, *supra* note 132 (concerning the University of Colorado).

THE BURDEN OF PERSUASION: AFFIRMATIVE ACTION, LEGACIES, AND RECONSTRUCTING HISTORY:

A REVIEW OF RUSSELL K. NIELI'S *WOUNDS THAT WILL NOT HEAL: AFFIRMATIVE ACTION AND OUR CONTINUING RACIAL DIVIDE* & RANDALL KENNEDY'S *FOR DISCRIMINATION: RACE, AFFIRMATIVE ACTION, AND THE LAW*

MICHAEL A. OLIVAS*

Russell K. Nieli's *Wounds that Will Not Heal: Affirmative Action and our Continuing Racial Divide* is published by Encounter Books and is described on the copyright page as "an activity of Encounter for Culture and Education, Inc."[1] The publishing company has recently released a series of conservative and libertarian books, including the following: *The Great Global Warming Blunder* (Roy W. Spencer); *Never Enough: America's Limitless Welfare State* (William Voegeli); *President Obama's Tax Piracy* (Peter Ferrara); and my personal favorite, *The Grand Jihad: How Islam and the Left Sabotage America* (Andrew C. McCarthy), which is advertised as "a harrowing account of how the global Islamist movement's jihad involves far more than terrorist attacks, and how it has found the ideal partner in President Barack Obama, whose Islamist sympathies run deep."[2] I situate Nieli's 2012

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1. RUSSELL K. NIELI, WOUNDS THAT WILL NOT HEAL: AFFIRMATIVE ACTION AND OUR CONTINUING RACIAL DIVIDE (2012).

2. *See The Grand Jihad: How Islam and the Left Sabotage America*, ENCOUNTER BOOKS, http://www.encounterbooks.com/books/the-grand-jihad-paperback (last visited May 25, 2014).

work alongside the company it keeps: abject failures of the secular state, general accusations of the country's godlessness, and other evidence of false liberal pieties. Any anti-affirmative action book that begins by invoking Gandhi and Dr. Martin Luther King Jr. in its epigraph attempts to alert its readers that it is being fair and balanced. However, the first page pierces that veil. Consider the following:

> Racial preferences in the U.S. first arose in response to the widespread rioting in the urban black ghettos of America during the late 1960s. As a result of these urban upheavals, concerned elites in the federal bureaucracy and federal courts, as well as the top universities and law schools, concluded that much more had to be done to deal with the pressing problem of black poverty and alienation in America than could be achieved through the prevailing ideal of color-blind justice, which had done so much to inspire the 1950s and 1960s era civil rights movement.[3]

Such a breathtaking *tour de force* of the inspirational color-blind 1950s and 1960s civil rights era would, were it not so risible, be suspect if only to see whether anyone was reading the Introduction.

But, in the kind of inaccurate rendering of events that characterizes this work, Nieli's very first footnote states that President Johnson was "probably thinking of a huge expansion of Great Society training and other programs rather than racial preferences" when he "issued Executive Order 11375 reaffirming in unmistakably clear and forceful terms the requirement for color-blind, nondiscriminatory, merit-focused hiring for all federal contractors."[4] Well, President Johnson was "probably" doing nothing of the sort when he signed into law this Executive Order banning *sex-based* discrimination. In his final chapter, over two-hundred pages later, Nieli mentions—without citation—President Richard Nixon's 1969 revised "Philadelphia Plan" as the "first of the national 'affirmative-action' initiatives."[5] This bookend of incomplete historical citation—almost passing over President Kennedy's Executive Order 10925, which employed the term "affirmative action," and confusing the purposes of the different Executive Orders and Plans and Revised Plans—is, as so much of this book is, off by a tick and wrong. I confess that it takes a certain moxie to start with Gandhi and King and, within one page, switch to inaccurate and extraordinary renditions of color-blindness. In fairness, I read a lot of this history and, as others in my boomer generation, lived through much of it, but I cannot recall

3. NIELI, *supra* note 1, at 9.
4. *Id*.
5. *Id.* at 338.

having encountered so little nuance in a work dedicated to these major legal issues in the last seventy-five years of higher education.

Nieli asks for this harsh reading in light of his smarmy style throughout, as when he shows false modesty in laying out his thesis and choices of argumentation:

> Some will feel that in the following materials I have been much too harsh on preference policies and their supporters, that I look only at the downside of the policies, and that I ignore all the good that they have done. In response to such criticisms, I will just say that on balance not only have 40+ years of racial preferences policies had overwhelmingly negative consequences, but that if one looks closely enough at the various "goods" they are supposed to have achieved, the "goods" almost always turn out to be so intimately tied to countervailing "bads" that their supposedly positive value cannot be unambiguously placed in any plus column.[6]

Just for the record, I had been lured into carefully reading Nieli's book precisely because I had hoped to find a thoughtful, accurate, and cumulative reading of this vexing literature on the continuation of affirmative action—whether or not, at the end of the day, I would be convinced by it. After all, Nieli examines important higher education policies: college admissions, alumni privilege, stereotype threat, the use of socioeconomic status as a proper criterion for college admissions, fundamental fairness, minority colleges, the reach of equal protection, the mismatch theory controversy, and other difficult and complex issues about which reasonable people can write extensively, cross swords, and live to disagree. That project is not accomplished by this book. While each of the policies deserves review, in this Book Review I look at alumni privilege carefully and then suggest why I think Nieli's effort falls so short, especially in contrast to the more satisfying, though no less ambitious, project by law professor Randall Kennedy, in his *For Discrimination Race, Affirmative Action, and the Law*.

To the extent that snarkiness, performed properly, can be a form of nuance, Nieli's putdown of William Bowen and his Mellon Foundation-funded colleagues as "River Pilots" was clever and original, as their series of books likened admissions policies to "the River."[7] Because I had

6. *Id*. at 14.

7. He flags "the three pro-affirmative action River Books sponsored by the Andrew W. Mellon Foundation." *Id.* at 21. He then spends Chapter V (Selling Merit Down the River) railing against their findings. *Id.* at 275–381. The trilogy includes WILLIAM G. BOWEN & DEREK BOK, THE SHAPE OF THE RIVER: LONG-TERM CONSEQUENCES OF CONSIDERING RACE IN COLLEGE AND UNIVERSITY ADMISSIONS (1998); DOUGLAS S. MASSEY ET AL., THE SOURCE OF THE RIVER: THE SOCIAL ORIGINS OF FRESHMEN AT AMERICA'S SELECTIVE COLLEGES AND UNIVERSITIES (2003); and CAMILLE Z. CHARLES ET AL, TAMING THE RIVER:

my own objections to that body of work, I found Nieli's analysis to be perhaps his lone contribution, although our takes were not in the least overlapping or symmetrical. I felt that Bowen and his colleagues did not take into account the relevant literature, that they mischaracterized the issues of Latino college students, and that the analysis of private college data was unlikely to shed light on litigation involving public college admissions.[8] Nieli largely objects to their support for affirmative action. Thus, my critique was about efficacy, whereas his critique was primarily about fairness to white students and the unfair advantage he feels that the books convey to the mismatched minority students.

Nieli did not object to the use of admissions preferences for athletes, an oddly-tolerant concession, but one that I found telling. He states,

> Though corrupting to intellectual standards, athletic preferences can at least be defended on the grounds that there are other forms of merit a college might acknowledge besides the strictly academic kind and that these might include, in addition to special musical or dance talent, the ability of an accomplished athlete. Whether or not one accepts this rationale, it is hard to see mere membership in an 'underrepresented minority group' as a form of nonacademic talent comparable to that of being an accomplished athlete or musician—although some have tried valiantly to defend this claim.[9]

Examine this legerdemain carefully: in other words, such nonacademic criteria can be advanced and defended because, well, they can be advanced and defended and at least they are not race. This feckless circularity resembles Fifth Circuit's language in *Hopwood v. Texas,* language that Nieli may have taken to heart and made his own: "A university may properly favor one applicant over another because of his ability to play the cello, make a downfield tackle, or understand chaos theory. An admissions process may also consider an applicant's home state or relationship to school alumni."[10]

NEGOTIATING THE ACADEMIC, FINANCIAL, AND SOCIAL CURRENTS IN SELECTIVE COLLEGES AND UNIVERSITIES (2009).

8. *See* Michael A. Olivas, *Shape of the Class*, 24 REV. HIGHER EDUC. 193 (2001).

9. NIELI, *supra* note 1, at 359–60.

10. Hopwood v. Texas, 78 F.3d 932, 946 (5th Cir. 1996). In turn, Judge Jerry Smith, the Fifth Circuit's author of the *Hopwood* decision, was likely inspired by Justice Powell's turn of phrase in *Bakke*, in which the Justice wrote, "[Diversity includes] city dwellers and farm boys; violinists, painters and football players; biologists, historians and classicists; potential stockbrokers, academics and politicians." Regents of Univ. of Cal. v. Bakke, 438 U.S. 265, 322 (1978).

Reading this section carefully, I was momentarily joyed when Nieli appeared to believe that legacy or alumni privileges are the same shibboleths that he found race and ethnicity to be. Did he and I have an overlap, a momentary eclipse where two moons hurtling in different directions aligned? I need not have worried, but the elision he performs merits special scrutiny: "Legacy admissions are more problematic. Like race, being a legacy or a child of a wealthy donor can't be justified as a special form of either academic or nonacademic merit, which is why so many people see something untoward about preferences based on these factors."[11] But then remember that magic is largely a nuanced form of misdirection: "But legacy and wealthy-donor preferences are rarely opposed with the vehemence of racial preferences, in part because most people realize that private colleges and universities are dependent on private funding to survive and that loyal alumni donors (and generous nonalumni [sic] donors) are often important sources of such funding."[12] In other words, legacy admissions are an unprincipled necessity because they bring money with them. Never mind that Nieli spent more than three-hundred previous pages saying that *wealthy* minorities are the predominant beneficiaries of affirmative action—I mean, racial preferences. But, not to put too fine a point on it, anyone who defends non-alumni donor privilege, as he does, has surrendered the right to any high resentment he might feel from those unfair admissions to the unwashed. To add insult to injury, Nieli also cavalierly cites the music from *Cabaret* for the proposition that "money makes the world go around."[13] Well, money and outrage over ascribed minority privileges make his world go around. One can only wonder if all the white beneficiaries of unearned privilege suffer from the same withered self-concepts over ill-gotten and unearned gain that he clumsily insists minorities either suffer from, or should suffer from. Nieli's book inconsistently and unpersuasively treats this issue, and it is a dictionary example of one man protesting too much.

Also, is it impolite to note that in the University of Michigan admissions cases, U.S. Federal District Court Judge Patrick Duggan stated that "there [was] no overall discriminatory impact"[14] regarding university

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11. NIELI, *supra* note 1, at 360.
12. *Id.*
13. *Id.* at 361.
14. Gratz v. Bollinger, 135 F. Supp. 2d 790, 801 (E.D. Mich. 2003)

> [D]ue to the University's past history of discrimination, it is less likely that a minority student will receive any alumnus "A" (alumni) points. Furthermore, minority students are less likely to reside in the forty-five northern Michigan counties that the University identifies as underrepresented under its "G" (geography) factor. In this Court's opinion, Defendant-Intervenors' reliance upon the discriminatory impact of the other SCUGA factors is misplaced as the SCUGA factors are but one compo-

alumni privileges? Judge Duggan failed to analyze admissions through a racial lens, even though, in most years, the legacy points were a greater factor in more admissions decisions at the University of Michigan than its affirmative-action practice. The same was true at Texas A&M ("TAMU") when, after *Grutter's* repudiation of *Hopwood*, TAMU announced it would not use affirmative action, so as to emphasize merit, but without announcement, it kept its Aggie-legacy points in place.[15] The four points (on a scale of 200) that TAMU awarded to legacies resulted in more white admits in any year of the practice than the number of minorities admitted in those years as freshmen. TAMU was publicly embarrassed into conceding the inconsistency and dropped its alumni preferences. But shouldn't the presumption be that public institutions do not need to resort to this practice? Although the number of legacy points seems small, the costs of the practice are significant. Minority admissions officers, and even minority legislators, have told me that, in time, legacy admissions will work so black and Latino parents can eventually pass the privilege to their children. I believe this eventuality is chimerical and will simply never come true, given the large number of white alumni whose children apply to college and the few minorities who are similarly situated. Graduation data suggest that the arc of such admissions, at selective public institutions in Texas, will never improve to the point where alumni privilege produces a substantial number of minority students. Even Justice Sonia Sotomayor was recently taken in by this false new math, when she appeared to be convinced that discontinuing legacy admissions was simply moving the goalposts on minorities.[16]

I will grant Nieli this: he does raise legitimate arguments about un-

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> nent of the overall race-conscious admissions programs that Plaintiffs seek to invalidate. Because both the allegedly discriminatory SCUGA factors and the racial preferences are part of the same program, there is no overall discriminatory impact.

Id. (internal citations omitted).

15. After the *Grutter* decision, TAMU decided it would not employ racial affirmative action and announced plans accordingly. However, it maintained its alumnus privilege points, which helped admit more white students each year than the number of minority freshmen under any circumstances. When the incongruity came to light after a critical op-ed, TAMU retreated. *See* Todd Ackerman, *Texas A&M Abolishes Legacy Program*, HOUS. CHRON., Jan. 10, 2004, at A1.

16. Justice Sotomayor, in *Fisher* oral arguments, noted with regard to alumni privilege, "[i]t's always wonderful for minorities that they finally get in, they finally have children and now you're going to do away for that preference for them. It seems that the game posts keeps changing every few years for minorities." *See* Scott Jaschik, *Surprise on Legacy Admissions*, INSIDE HIGHER ED (Oct. 16, 2013), http://www.insidehighered.com/news/2013/10/16/unexpected-exchange-supreme-court-alumni-child-preferences#sthash.gdXicr9O.dpbs.

fairness, although he does a poor job differentiating between reparations theories and the mistaken logic of *Bakke,* in which the idea of diversity first reared its head. It could have been useful for him to show how diversity logic privileges race and why that is worse than privileging class or any other non-meritorious criterion. For example, I would have listened carefully and likely agreed with a thoughtful discussion of why Cheryl J. Hopwood's life history and backstory should or should not give way to that of, say, a Chicana similarly situated. After all, Hopwood had a daughter with a disability, had working class roots, and possessed other attractive traits. I would have voted for her, and over the years, I have gladly voted for admissions of many of her kith and kin. I certainly would not have voted against her due to her having attended CSU-Sacramento, as apparently happened.[17]

The entire purpose of Nieli's book is to show the harmful and unprincipled effects of affirmative action. Carl Cohen, a reviewer who appreciated this book much more than I did, wrote the following about the Nieli work:

> Preference by race is wrong. We all know that. Even those who advocate it often do so abashedly, hiding or obfuscating what they do, and not seldom lying about it. They believe sincerely that the products of such preference are so very good that we must accept the need to put aside for a while the

17. *See* Hopwood v. Texas, 861 F. Supp. 551, 564–65 (W.D. Tex. 1994), *rev'd*, 78 F.3d 932 (5th Cir. 1996), *cert. denied*, 518 U.S. 1033 (1996).

> Cheryl Hopwood had a [Texas Index] of 199, which placed her in the resident presumptive admit range. Hopwood's TI reflects a 3.8 grade point average and an LSAT score of 39. Hopwood's application indicates she received an associate's degree in accounting from Montgomery County Community College in May 1984 and a bachelor's degree in accounting from California State University in Sacramento in 1988. The application further indicates she is a certified public accountant in California, she worked twenty to thirty hours a week while obtaining her undergraduate degree, and she was active in Big Brothers and Big Sisters in California. Hopwood submitted an additional letter to the law school dated January 22, 1992, requesting permission to attend law school on a limited basis the first year, if accepted, because of the needs of her child, who had been born with cerebral palsy. Hopwood's application file contains no letters of recommendation. Additionally, her responses to the questions are brief and do not elaborate on her background and skill. She provided no personal statement with the application.
>
> After his initial review of Hopwood's file, [Admissions Committee Chair Professor Stanley] Johanson dropped her from the presumptive admission zone to the discretionary zone because, in his evaluation, she had not attended schools that were academically competitive with those of the majority of the applicants, had a large number of hours at junior colleges, and was able to maintain a high GPA although working a substantial number of hours.

Id. at 564 (notes omitted).

> principle that the races are equal and ought always to be treated equally.
>
> Russell Nieli, very much to the contrary, contends that the products of race preference, or affirmative action, are bad—very, very bad. Their consequences, for all concerned, are dreadful. He is correct. The object of *Wounds That Will Not Heal* is to prove this badness: to illustrate it, to explain it, and to drive it home as forcefully as it is possible to do.[18]

As Cohen notes, Nieli usefully catalogues all the available arguments against affirmative action, citing chapter and verse from the various research studies over the years that have formed the internal logic of conservative responses to the policy. As the aforementioned Cohen summarizes, "the products of race preference, or affirmative action, are bad—very, very bad."[19]

One final pivot on which Nieli rests his logic is that he cites Randall Kennedy's suggestion from an earlier writing that merit "is a malleable concept, determined not by immanent [sic], preexisting standards."[20] As his convoluted attempt to justify the unfortunately-necessary and instrumentally-justified white privilege reveals, Nieli is of the same mind. In Kennedy's new book, *For Discrimination: Race, Affirmative Action, and the Law*, Kennedy argues that given the country's long history of racial discrimination—more pervasive than Nieli's inchoate and imperfectly-documented "prevailing ideal of color-blind justice, which had done so much to inspire the 1950s and 1960s era civil rights movement"[21]—some amount of discrimination against whites can be justified:

> The pertinent principle should be racial justice. How one effectuates that principle that involves all manner of complex sociological and political judgments. Under certain circumstances, nondiscrimination is probably the best vehicle available for attaining racial justice (or its closest practicable approximation). Under other conditions, however, racially selective affirmative action is a better vehicle. . . That is not to say that affirmative action is without risk and expense. As I have noted at some length, affirmative action does generate

18. Carl Cohen, *Both Wrong and Bad*, 26 ACAD. QUESTIONS 1 (2013), *available at* http://carl-cohen.org/docs/Spring%202013%20Academic%20Questions.pdf as.org/articles/both_wrong_and_bad.

19. *Id.*

20. NIELI, *supra* note 1, at 246. Trying to pin down his references is hard, in part because the Index is not always accurate, and in part because he does not always provide pin cites for quoted materials, leaving readers to read an entire book for a small point to which he has cited.

21. NIELI, *supra* note 1, at 9.

> toxic side effects—like many useful medicines. If the side effects outpace the therapeutic benefit, the medicine should be discontinued (though, it is hoped, replaced by something more suitable).[22]

This book, his fifth with Pantheon, is vintage Randall Kennedy, and while I have not always agreed with Kennedy's often-provocative take on issues, I remain quite fascinated at his courageous exploration of difficult subjects. I confess that Randy is a friend, and we had breakfast together last time I was at Harvard Law, about a year ago. I found his books, *Nigger: The Strange Career of a Troublesome Word*[23] and *Interracial Intimacies: Sex, Marriage, Identity and Adoption*,[24] quite moving and persuasive. I even admired and learned from his careful engagement with early, critical legal scholars of color, such as law professors Derrick Bell, Mari Matsuda, and Richard Delgado, in which he was both supportive of their projects while also deeply critical of what he considered to be the flaws in their work:

> I provide a historical context for the versions of the racial exclusion and racial distinctiveness theses that Bell, Delgado, and Matsuda articulate. I argue that their writings warrant close attention. They raise questions that are, or should be, central to any academic community. They share an intellectual kinship with several well-known and influential intellectual traditions. They express beliefs that are prevalent, deeply rooted, and consequential.
>
> . . . .
>
> At the same time, the writings of Bell, Delgado, and Matsuda reveal significant deficiencies—the most general of which is a tendency to evade or suppress complications that render their conclusions problematic. Stated bluntly, they fail to support persuasively their claims of racial exclusion or their claims that legal academic scholars of color produce a racially distinctive brand of valuable scholarship. My criticism of the Bell/Delgado/Matsuda line of racial critiques extends farther, however, than their descriptions of the current state of legal academia. I also take issue with their politics of argumentation and with some of the normative premises underlying their writings. More specifically . . . I challenge: (1) the argu-

22. RANDALL KENNEDY, FOR DISCRIMINATION: RACE, AFFIRMATIVE ACTION, AND THE LAW 243–244 (2013). After reading this book, I suspect that Professor Nieli will not be citing Kennedy as a racial moderate.

23. RANDALL KENNEDY, NIGGER: THE STRANGE CAREER OF A TROUBLESOME WORD (2002).

24. RANDALL KENNEDY, INTERRACIAL INTIMACIES: SEX, MARRIAGE, IDENTITY, AND ADOPTION (2003).

> ment that, on intellectual grounds, white academics are entitled to less "standing" to participate in race-relations law discourse than academics of color; (2) the argument that, on intellectual grounds, the minority status of academics of color should serve as a positive credential for purposes of evaluating their work; (3) explanations that assign responsibility for the current position of scholars of color overwhelmingly to the influence of prejudiced decisions by white academics.[25]

That Nieli misappropriates Kennedy's carefully nuanced and balanced work is all the more frustrating, as when he notes Kennedy's demurrers about the racial thermodynamics of affirmative action and diversity rationales and then transmogrifies them into lack of support for the concept. Nieli states that Kennedy,

> [H]as made similar comments casting doubt on the sincerity, if not the goodwill, of academic administrators who invoke "diversity" as their main reason for increasing the black presence in colleges and professional schools. . . . While Kennedy is generally supportive of racial-preference policies, he agrees with critics that the diversity rationale is a weak foundation on which to base one's defense of such policies, and is at best a secondary concern of many who support and maintain affirmative action policies for other reasons.[26]

In *For Discrimination: Race, Affirmative Action, and the Law*, Kennedy authoritatively examines the history of affirmative action, offers a frank appraisal of what he terms "the color-blind challenge to affirmative action," analyzes the role of affirmative action in U.S. Supreme Court decisions,[27] and concludes with a thoughtful defense of the concept, properly applied. In each of these sections, he draws from a wide range of scholarship, adds personal vignettes, and shows the math homework supporting his judgments. By this, I mean that he lays out the predicates, assesses the good and bad of each dimension, and honestly explains how he got to that point. My favorite vignette is one that I am hereby appropriating, even if I might skip the attribution:

> In assessing my own record, I try to maintain equanimity, knowing that on account of race I have sometimes been penalized and sometimes been preferred. I do my best and hope

25. Randall L. Kennedy, *Racial Critiques of Legal Academia*, 102 HARV. L. REV. 1745, 1747–49 (1989).

26. NIELI, *supra* note 1, at 246.

27. Despite writing the book before 2013, he includes in his consideration of U.S. Supreme Court decisions the Court's most recent case, Fisher v. University of Texas at Austin, in which the Court remanded the matter to the federal appellate court for consideration of the policy's "narrow tailoring." *Id.* at 27. *See generally* Fisher v. University of Texas at Austin, 133 S. Ct. 2411 (2013).

> that my work meets high standards. I realize, though, that judgment is social, contingent, and subject to forces beyond my control. Does my status as a beneficiary of affirmative action oblige me to support it? Absolutely not. Mere benefit from a policy imposes no obligation to favor or defend it.[28]

This is as good a defense and justification of the policy as I have ever read. As was shown in terms of alumni privilege, societal advantage, and wealth, more whites should adopt it as their mantra.

My only quibble with Kennedy's book derives from one of the case studies he uses to discuss admissions percentage plans. He begins his treatment of *Fisher* quite straightforwardly, noting:

> Most Americans want to escape the gravitational pull of the country's ugly racial past. If affirmative action is required to effectuate that ambition, they will accept it, albeit in disguise. Affirmative action disguised in plain sight includes "race-neutral" policies established for the purpose of elevating blacks and other marginalized groups but making no reference to race in their packaging. Texas's Top Ten Percent Plan is such a policy.[29]

He goes on to describe the policy, although he does not drill down very deeply into the details. Given the mistaken racial-paternity assumed even by Justice Ruth Ginsburg in her dissent in the *Fisher* remand,[30] I take this opportunity to elaborate on and correct the per-

28. KENNEDY, *supra* note 22, at 11.

29. *Id.* at 240–41.

30. Justice Ginsburg's dissent spares no snark in describing the Plan, which Fisher did not challenge:

> Petitioner urges that Texas' Top Ten Percent Law and race-blind holistic review of each application achieve significant diversity, so the University must be content with those alternatives. I have said before and reiterate here that only an ostrich could regard the supposedly neutral alternatives as race unconscious. As Justice Souter observed, the vaunted alternatives suffer from "the disadvantage of deliberate obfuscation." Texas' percentage plan was adopted with racially segregated neighborhoods and schools front and center stage.

Fisher, 133 S. Ct. at 2433 (2013) (Ginsberg, J., dissenting) (internal citations omitted). She also drops a devastating footnote:

> The notion that Texas' Top Ten Percent Law is race neutral calls to mind Professor Thomas Reed Powell's famous statement: "If you think that you can think about a thing inextricably attached to something else without thinking of the thing which it is attached to, then you have a legal mind." T. Arnold, The Symbols of Government 101 (1935) (internal quotation marks omitted). Only that kind of legal mind could conclude that an admissions plan specifically designed to produce racial diversity is not race conscious.

Id. at 2433 n.2.

centage plan record.

After *Hopwood* began to frag its way through Texas, State Representative Irma Rangel (D-Kingsville), the chair of the Texas House Committee on Higher Education, convened a small working group composed of Latino professors and attorneys from the Mexican American Legal Defense and Educational Fund (MALDEF) to advise her on a legislative response. Inasmuch as the decision had the effect of banning the use of race in admissions to the state's public colleges, the group—which varied between six and ten members and to which I belonged—met monthly in Austin to plot a completely race-neutral response. We began an intensive scholarly reading program, took note of legal and legislative developments in other states (particularly California) and undertook computer simulations to counter the immediate and detrimental effects of *Hopwood*. After more than nine months of meetings, we settled on a refined version of the California Master Plan ("Master Plan"). It had a longstanding tiered-model with open admission community colleges for freshman and sophomore classes, moderately selective junior-senior upper division institutions in the California State University System, and the more elite and selective University of California ("UC") System, which drew from the top 12.5 percent of the state's high schools under a complex UC-eligible formula that weighted grades and mandatory test scores.[31] While the Master Plan was decades old and had been revised to accommodate the state's growth and resources, UC campuses were still extremely competitive and bursting at the seams.[32]

In contrast, Texas had a more decentralized plan, with over a dozen individual college systems, most with multiple campuses and no centralized admissions model. As noted, TAMU used alumni privilege. The University of Texas at Austin (UT-Austin), as the most selective and popular campus in that multiple-institution statewide system, faced a number of constraints; on the other hand, there were other campuses and systems that were under-capacity or could grow (unlike the more space-limited UC campuses, such as those in Berkeley and Los Angeles). There were symmetries, such as the very competitive nature of the flagship programs, particularly at the UT-Austin campus, with one of the nation's largest enrollments, and limits on the number of full-time, first-time freshmen they could plausibly accept, competitive undergraduate majors such as Business and Engineering, as well as selec-

31. *See generally Admission Requirements*, UNIV. OF CAL., http://admission.universityofcalifornia.edu/freshman/requirements/index.html (last visited May 25, 2014).

32. Goldie Blumenstyk, *As Yudof Steps Down, Major Challenges Lie Ahead for the U. of California System*, CHRON. HIGHER EDUC. (Jan. 20, 2013), http://chronicle.com/article/Challenges-Ahead-for-the-U-of/136765/.

tive graduate and professional schools.

In our search to find a race-neutral alternative to *Hopwood's* restrictions, we took note that the UT-Austin campus had a very small range of high schools that served as "feeder schools" to the campus, sometimes sending almost twenty percent of a selected high school's graduating class to the campus, and a number of counties and high schools in the sprawling state that were less-inclined to send their students to the campus. We found more than two-dozen counties that had not sent a successful applicant to UT-Austin in over a decade, particularly from the more-remote eastern and western rural counties and schools. We did not take into account the racial character of those schools, although we certainly realized that the growing percentage of African-American and Mexican-American students were concentrated in the larger cities and, in the case of the Latino students, in the Rio Grande Valley, roughly along the state's border with Mexico, in a swath from Laredo/Nuevo Leon East to Brownsville/Matamoros.

The state had recently upgraded the border colleges and re-aligned them with either the UT or TAMU systems, as a result of a MALDEF case, [33] but the Texas Supreme Court had subsequently overturned a lower court decision that had held the State had intentionally favored the more northern areas, harming Mexican-Americans who were concentrated along the border and in San Antonio.[34] One authoritative case study of the *LULAC v. Richards* litigation characterized the unanimous Texas Supreme Court decision as "unsound" inasmuch as it ignored the "centrality of race and racism and the intersectionality of racism with other forms of oppression."[35] I found the combination of the successful upgrading of border colleges and the *Richards* defeat to be "the antonym of a pyrrhic victory—perhaps a victory notwithstanding the verdict."[36]

The computer runs were most promising for adding Mexican-Americans and, to a lesser extent, African-Americans (who had access to several private historically black institutions and two public ones) under one scenario: an automatic admissions policy that replaced the SAT or ACT requirement with the condition of graduating from a state

33. *See generally* Clements v. League of United Latin Am. Citizens (LULAC), 800 S.W.2d 948 (Tex. App. 1990), *abrogated by* M.D. Anderson Cancer Ctr. v. Novak, 52 S.W.3d 704 (Tex. 2001).

34. Richards v. League of United Latin Am. Citizens (LULAC), 868 S.W.2d 306 (Tex. 1993).

35. RICHARD R. VALENCIA, CHICANO STUDENTS AND THE COURTS: THE MEXICAN AMERICAN STRUGGLE FOR EDUCATIONAL EQUALITY 267 (2008).

36. MICHAEL A. OLIVAS, SUING ALMA MATER: HIGHER EDUCATION AND THE COURTS 119 (2013).

high school in the top twenty percent. We feared that such a program, even if only a small number of the eligible students enrolled, would swamp three or four of the flagship schools—perhaps UT-Austin, TAMU-College Station, University of Houston, and UT-Dallas—and that a larger percentage of graduates attending a given campus would prove problematic in its own way.

Ultimately, we settled on the Top Ten Percent Plan ("Plan"), which guaranteed admission to high school graduates who were in the highest decile of their graduating classes. We discussed, but discounted, any perfidy by parents to manipulate the high schools that their children would attend, assuming that parents' quest to improve their students' chances would not entice them to manipulate residency or to move. We also assumed that schools would continue to rank their graduates rather than hide the ball by flattening the class rank and not recording it for college purposes. We sold the plan on broad participatory grounds and stressed the widespread notion that doing well in school was a good indicator of quality, one often incorporated into choices of valedictorian, and that high rank-in-class was often used as a proxy for college readiness. We successfully sold it to legislators by stressing the simplified process, one to be fairly applied across all schools, and one likely to result in a signal to high school students, school counselors and advisors, and parents. I recall one white, rural legislator's surprise when he was informed that no one from his district's largest high school had been admitted into UT-Austin for over a quarter century, and I recall a pleasant discussion with a lawyer, who had litigated *Hopwood* and gone on to become an education attorney-advisor to then-Governor George W. Bush. As it turned out, he was from a small rural district, and he immediately offered to pitch the plan to the governor.

In a state where whites are a declining proportion and total number of the public school population, the Plan was sure to spread out the applicants and enrollees. But it was not at all clear it would do so disproportionately for students of color, and it did not ultimately do so. The after-the-fact quarterbacking that now seems afoot is simply wrong. This plan was not race-specific; rather, it was crafted to survive the hostile post-*Hopwood* politics and potential legal challenges, and it was intended to reduce the effect of the standardized tests on the system. To describe it as race-neutral is particularly appropriate in its as-applied optics, as over half of all students admitted under the Plan (now reduced to less than ten percent for UT-Austin, after the campus received an exemption on the grounds that the enrollment under the original Plan had swamped them and left them with no room for discretionary admits) have been white,[37] in a state where whites constitute only slightly more than thirty percent of the total public school enrollment (if Latinos did not drop out of school at such an alarming rate, the percentage of white students would be even lower).[38]

That residential segregation in Texas is so pervasive that there are single-race high schools is no counter to the race-neutrality of the Top Ten Percent Plan. To assert otherwise requires a hermetically sealed perfect world where every school would be composed of the ideal percentage of students by group in the state. In my most nationalistic or nihilist moment, I would never claim that every unfair result is traceable to nativism or racial discrimination, but to the Abigail Fishers and Russell Nielis of the world, alumni privilege is an unfortunate necessity, and every minority student—a term to be used advisedly in Texas—is sitting in their seat or keeping them out. Indeed, *Fisher* is a special racial pleading, even as Abigail Fisher did not directly challenge the Plan. The mere existence of the Plan, which did not admit her, is evidence that the University of Texas must be using racial means to keep her out, even as *Grutter* allows the institution to employ racial admissions considerations in a modest way.[39] I am confident that minority-related cases will be brought with regularity when whites are more readily recognized as not constituting the majority. But I cannot expect Kennedy to know this insider baseball, and at least he took a swing at *Fisher* and at the percentage plan issue.

One last signpost: Kennedy is a scholar with broad and wide-ranging interests, and one of his most admirable works is his loving article on his mentor, Supreme Court Justice Thurgood Marshall.[40] He has also written a comprehensive and authoritative analysis of the centrality of the Montgomery Bus Boycott, in which he situates the moral and political force of Dr. King.[41] Although I am certain that he did not have Nieli

37. The Top Ten Percent Plan was altered in 2009 for the UT-Austin campus, after years of special pleading. *See generally* Scott Jaschik, *10 Percent Plan Survives in Texas*, INSIDE HIGHER ED (May 29, 2007), http://www.insidehighered.com/news/2007/05/29/percent#ixzz2jms2Abd8; Scott Jaschik, *Texas Limits '10%' Admissions*, INSIDER HIGHER ED (June 1, 2009), http://www.insidehighered.com/news/2009/06/01 /texas#ixzz2jmt30i54.

38. *See* Table 4, *Enrollment by Race/Ethnicity, Texas Public Schools, 2001-02 Through 2011-12*, TEXAS EDUCATION AGENCY, ENROLLMENT IN TEXAS PUBLIC SCHOOLS 2011-12 8 (2012), *available at* http://www.tea.state.tx.us/acctres/enroll_index.html.

39. *See* Grutter v. Bollinger, 539 U.S. 306 (2003).

40. Randall Kennedy, *Doing What You Can with What You Have: The Greatness of Justice Marshall*, 80 GEO. L.J. 2081 (1992). Particularly noteworthy in his narrative is the discussion of how Justice Marshall used dissents to cert denials to keep death penalty abolition discourse flowing. *Id.* at 2082–2091.

41. Randall Kennedy, *Martin Luther King's Constitution: A Legal History of the Montgomery Bus Boycott*, 98 YALE L.J. 999 (1989).

specifically in mind, he impatiently writes, "[p]reviously I noted how opponents of racial affirmative action frequently, albeit inaccurately, invoke [Rev.] King for moral authority. That misappropriation should cease."[42] I could not help but wonder if that curt admonition extended to citing both King and Gandhi. Kennedy's book is only half the length of Nieli's, but it has twice as much analytic power and actually grapples with the complexities of the relevant issues. Nieli deals in elliptical reasoning and ditties, as in one inexplicable and anonymous piece of "feisty doggerel" that he drops in an unattributed footnote: "Merit Can, Merit Must, Be the Basis of Our Trust! So Hey, Hey, Ho, Ho, Racial Preference Gotta Go!"[43] If you want very old doggerel frozen in amber, try Nieli's book. If you want a book warm to the touch, with heft and seriousness, then take the time to read Kennedy's work. It will be time well spent.

42. KENNEDY, *supra* note 22, at 243.
43. NIELI, *supra* note 1, at 274.