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Nonprofit Update: New Law Permits Increased Flexibility in Expending and Managing Charitable Funds

By Ellis M. Carter, Kendis K. Muscheid, Laura A. LoBianco and Christian M. Olson

Charitable institutions now have expanded ability to access restricted funds. In July of 2006, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") adopted the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). To date, twenty-five states, including Arizona, have enacted some version of the UPMIFA. Arizona's version of UPMIFA, titled the "Management of Charitable Funds Act," was effective in September of 2008 and can be found at A.R.S. Sections 10-11801 through 10-11805 ("the Act").

Prior to UPMIFA's adoption, the prevailing law across the country was the 35 year-old Uniform Management of Institutional Funds Act ("UMIFA"). UPMIFA and UMIFA serve as the default rules governing charitable institutions' expenditures of restricted funds and investment conduct when there are no express terms that control the gift, such as might be set forth in a gift agreement. UMIFA was also the law in Arizona, known as the "Investments for Eleemosynary Purposes Act," but was repealed in favor of the Act.

The Act is retroactive in that it applies to charitable funds existing on or established after the effective date of the Act (September 15, 2008 in Arizona). With respect to funds that were already in existence on the effective date,[1] the Act applies only to decisions made or actions taken with respect to such funds after the effective date. The Act applies to charities organized as nonprofit corporations and to charities organized as trusts, but only to those trusts with a charity as a trustee.

Key Changes Made By UPMIFA

<u>Elimination Of The "Historical Dollar Value" Limit</u>

UPMIFA's provisions permit charitable institutions to expend or accumulate endowment and other charitable funds in a prudent manner. During times of economic strength, accumulation may be prudent. During economic downturns, expenditures may be prudent, even though the fund has no investment return.

Under the old law, whenever the value of an endowment fund dipped below the fund's initial value at the time the gift was made (its "historic dollar value") no expenditures could be made. Funds that have dipped below their initial value are known as "underwater" funds. Previously, donor or court approval was required to make any expenditure from an underwater endowment fund. In contrast, the Act specifically permits trustees of endowment funds to spend a "prudent" portion of the fund, even if such spending dips into principal from time to time.

1 UPMIFA does not change standard accounting for funds. For instance, for accounting purposes, funds received as "true" endowments are classified as permanently restricted. Funds subject to a restriction that the Board can satisfy – such as a timing restriction or purpose restriction – are classified as temporarily restricted. Funds received with no donor-imposed restrictions are classified as unrestricted.

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In Arizona, decisions to spend or accumulate endowment funds must be made in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and consideration of certain enumerated factors such as:

- the duration and preservation of the endowment fund;
- the purposes of the institution and the endowment fund;
- general economic conditions;
- the possible effect of inflation or deflation;
- the expected total return from income and the appreciation of investments;
- other resources of the institution; and
- the investment policy statement of the institution.

UPMIFA includes a standard of imprudence, creating a rebuttable presumption of imprudence when an institution spends more than 7% of the fair market value of an endowment fund in a given year. The Arizona legislature chose not to include the presumption of imprudence and instead chose to rely exclusively on the factor test discussed above. Even so, Arizona institutions should keep this presumption in mind as the development of case law in other jurisdictions may influence how Arizona courts interpret the prudence standard.

To take advantage of the Act's new flexible spending provisions with respect to future contributions, charitable institutions should revise their form gift agreements and expenditure policies to authorize the expenditure of a "prudent amount" of endowment funds pursuant to the Act and to strike any express limits on the expenditure of principal or the preservation of "historic dollar value."

The Act's retroactive application may permit a charitable institution to access existing underwater funds that were inaccessible under the old law. To determine whether an institution is able to access additional funds, an institution should review its existing spending and endowment policies and gift instruments. Where the expenditure provisions in the existing policies or gift instruments do not override the Act, the institution may rely on the Act's more flexible, default spending rules.

If an institution's policies are more restrictive than the Act or if a gift instrument (including the solicitation materials that garnered the gift) contains a specific promise, then the provisions in the policies or the promise in the gift instrument will overrule the Act's default spending provisions. In these circumstances, a charitable institution may need to obtain donor consent or court approval to deviate from the stated purposes or spending restrictions contained in the original policies or gift instrument.

<u>Methods To Release or Modify Restrictions On Funds</u>

Previously, gift restrictions could only be modified or released by the original donor or by a court under limited circumstances. The Act now provides for several additional methods of modifying or releasing restrictions.

For "small, old" funds in Arizona with a total value less than $50,000 (the amount varies from state to state) that are more than 20 years old, the Act provides a non-judicial process for the release or modification of certain gift restrictions. Specifically, if the gift restrictions are unlawful, impracticable, impossible or wasteful, they may be modified so long as the property is used in a manner the institution reasonably determines to be consistent with the charitable purposes expressed in the gift instrument. The institution with a fund fitting the above criteria may submit a plan of release or modification to the Attorney General for approval. If the Attorney General fails to object to the plan within 60 days, it is automatically approved.

The Act now makes clear that the trust law doctrines of cy pres (modifying a purpose restriction) and equitable deviation (modifying a management restriction) apply to institutional funds held by charities. Thus, if a fund does not fit within the criteria for release of restrictions as a small, old fund, and donor consent is not obtained, the institution may petition the courts for the modification or release of the restrictions. Under these available alternatives, the institution needs to demonstrate that the restrictions on the endowment fund have become unlawful, impracticable, impossible, wasteful, or an impairment to the management or investment of the fund and provide notice of the petition to the Attorney General. An institution with several funds needing modification and/or release of restrictions may be able to consolidate requests into a single petition in order to conserve costs, but such consolidation may only be effective if the petitions are not contested by donors.

Additional UPMIFA Changes

Incorporation of Modern Portfolio Theory. A key motivation for the revision of the 1972 UMIFA was to reconcile the law governing charitable institutions with modern investment practice. The revised Act incorporates modern portfolio theory, permitting more efficient management of funds for charitable purposes.

Revised Standards of Investment Conduct. The Act imposes an express duty of loyalty in making investment decisions and an express duty to manage costs. The Act also includes an express requirement that portfolios in institutional funds be diversified and periodically rebalanced. Finally, under the Act, a person with special skills or expertise who was selected to invest funds in reliance on the representations of special skills has a duty to use those skills in managing or investing institutional funds.

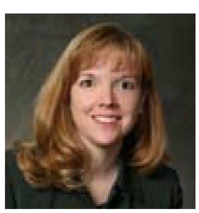
Permits Investments To Be Mission Influenced. The Act revises the factors that governing boards may consider when investing institutional funds. The revision bolsters the institution's ability to make mission influenced investments by including "[a]n asset's special relationship or special value . . . to the charitable purposes of the institution," as one factor charitable institutions may consider when making investment decisions.

Ellis M. Carter focuses her practice on advising tax-exempt and non-profit organizations with respect to corporate, tax and regulatory issues. She represents non-profit organizations in matters such as qualification for tax exemption, conversions to and from tax-exempt status, mergers and restructuring, joint ventures and entrepreneurial activities, maintaining or obtaining favorable tax-treatment, creation of supporting organizations, unrelated business income tax, advocacy issues, charitable solicitations, endowment management, governance issues, compensation matters, intermediate sanctions, and tax-exempt bond financing. Ms. Carter has a particular interest in health care/scientific research institutions, grant-making foundations, and educational institutions. She received her B.A. (1994) from Northeastern University, her J.D. (1996) from Seattle University and her L.L.M. (1998) from the University of Washington.

Kendis K. Muscheid practices primarily in the areas of nonprofit and tax-exempt organizations, charitable trusts, and state and local taxation. Ms. Muscheid advises a wide variety of tax-exempt Section 501(c)(3) organizations, varying in size and charitable purposes, including private foundations, supporting organizations, charter schools, research entities, religious organizations, arts organizations, and an array of other types of public charities. Ms. Muscheid is listed in Best Lawyers in America®, Tax Law, 2006. She received her B.B.A. (1986) from Texas Tech University and her J.D. (1991) from the University of the Pacific McGeorge School of Law.

Laurie A. LoBianco focuses her practice on corporate law and transactional matters. Her general corporate experience includes business counseling, formation of organizations, including joint ventures, non-profit corporations and limited liability companies; and maintenance of requisite organizational records. She also has experience with mergers and acquisitions; purchase, sale and lease of real property; and negotiation of contracts, including intellectual property licensing, independent contactor, employment, and equipment and service purchase contacts. She received her B.S. (1993) from Arizona State University and her J.D. (1996) from Santa Clara University, School of Law.

Ellis M. Carter
Director
602.916.5493
ecarter@fclaw.com



Kendis K. Muscheid
Director
602.916.5354
kmuscheid@fclaw.com

Laura A. LoBianco
Director
602.916.5345
llobianco@fclaw.com