Nonprofit Institutions Advisory: Proposed UPMIFA Legislation Will Increase Flexibility in Spending and Management of Endowment Funds

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On June 2, 2009, a joint Judiciary Committee of the Massachusetts Legislature held a hearing to receive public comment on Senate Bill 1783 that proposes enactment of the Uniform Prudent Management of Institutional Funds Act (UPMIFA). In recognition of the mounting financial pressures impacting many charitable organizations, representatives of key sectors of the Massachusetts nonprofit community testified in support of prompt passage of the proposed legislation. Senator Robert A. O'Leary, the bill's sponsor, urged the Legislature to pass the bill by June 30th thereby enabling organizations with June 30 fiscal year ends to forecast the extent to which they may use endowment funds when budgeting for their upcoming fiscal year. We will continue to closely monitor the progress of the proposed legislation and keep you advised when appropriate.

If enacted, the proposed legislation would provide additional flexibility and much needed clarity to charitable organizations with respect to the manner with which they deal with their endowment funds. One key change would enable a charity to spend from the principal of an endowment fund upon a good faith determination that such spending is prudent in light of the use, benefit, purpose and duration for which the fund was established. This would be a departure from existing Massachusetts law which constrains a charity to spend only the "net appreciation" of endowment assets over historic dollar value, and prohibits an organization from spending endowment principal. The change could have a significant impact on a charity prevented by existing law from making necessary expenditures because its endowment fund currently may have little or no net appreciation over historic dollar value. The following provides background and an overview of the key proposed changes to be effected if UPMIFA is enacted.

Background

The existing law, the Uniform Management of Institutional Funds Act (UMIFA), has been in effect in Massachusetts since 1975, and provides guidance to charitable organizations with respect to their investment, management and spending (also referred to as "appropriation") of endowment funds. UMIFA includes, among other things, rules dealing with the use of endowment fund assets and guidelines for the release of restrictions on use and the management of endowment funds. In 2006, the National Conference of Commissioners on Uniform State Laws (Conference of Commissioners) approved a revised version of UMIFA, commonly referred to as UPMIFA. UPMIFA is intended to provide modern guidance as to the prudence standards that apply to the investment and management of endowment funds, and to enhance an organization's flexibility in dealing with fluctuations in the value of an endowment. UPMIFA has been adopted in 34 states and the District of Columbia, and is currently under consideration or pending enactment in 11 other states.[1] The version of UPMIFA currently proposed in Massachusetts is identical to the model Act approved by the Conference of Commissioners, except as indicated in this Advisory.

Scope

UMIFA applies to "institutional funds" held by and used for the benefit of any type of entity established for religious, educational, or charitable purposes including certain governmental agencies.[2] Neither the current law nor the proposed legislation applies to funds established for charitable purposes held by individual trustees or commercial trustees, such as banks or trust companies, even if the sole beneficiary is a charity. Under UMIFA, institutional funds are those funds that an organization may spend currently together with its endowment funds, which are the portion of its institutional funds held for investment due to restrictions imposed by donors.[3] UPMIFA, as proposed, would apply to the same types of organizations; however, it also would apply to split-interest trusts existing after all non-charitable interests have terminated. UPMIFA would not apply to "program related assets," meaning those assets held to accomplish charitable purposes rather than for investment. The sole deviation of the currently pending Massachusetts legislation from the model Act is that the proposed legislation expressly includes within the definition of "institutional fund" a fund held by a trustee for a charitable community trust.

Similar to UMIFA, UPMIFA provides that a donor's intent, as set forth in a gift instrument defining the terms of the gift, is controlling and takes precedence over the statute. UPMIFA has broadened the definition of records that establish the terms of a gift to expressly include electronic records.

Endowment Spending

The current rules applicable to the spending of endowment assets apply when a charitable organization raises funds for its endowment and donors make contributions with the understanding that those funds will be held in the endowment. Under UMIFA, a charity is permitted to spend the amount of appreciation above "historic dollar value," or HDV, of an endowment fund, subject to certain limitations. HDV is the value of contributions made to an endowment fund without taking into consideration any subsequent appreciation or depreciation resulting from investment results, inflation or other causes. Under UMIFA, a charity is barred from spending below HDV.[4] In addition, the Massachusetts UMIFA provides that appropriation of net ***appreciation*** for spending in any year in an amount which is more than 7% of the 12-quarter average fair market value of the endowment fund creates a rebuttable presumption that the organization has acted imprudently.

The pending UPMIFA bill proposes to implement a major change with respect to endowment spending. First, the concept of HDV would be eliminated. Second, unless otherwise provided in a gift instrument and subject to the 7% spending limitation discussed below, UPMIFA would permit an organization to accumulate or spend as much of an endowment fund as the organization determines is prudent, provided the organization acts in good faith, with due care, and following consideration of seven specified factors (to the extent such factors are relevant) as outlined below.

The Conference of Commissioners comment on the model version of UPMIFA indicates that this departure from existing law (which ties the propriety of spending to HDV) would not result in a depletion of endowment funds, but rather would permit "an institution to maintain appropriate levels of expenditures in times of economic downturn or economic strength." Importantly, this approach shifts the focus to the purposes of the fund rather than the purposes of the organization, and places more importance on the perpetuation of the purchasing power of the fund in the future, rather than on the original dollar amount contributed to the fund.

UPMIFA requires an organization's governing body to consider seven factors (if relevant)[5] when deciding whether to spend or accumulate the organization's endowments as follows:

1. the duration and preservation of the endowment fund;
2. the purposes of the organization and the endowment fund;
3. general economic conditions;
4. the possible effect of inflation or deflation;
5. the expected total return from income and the appreciation of investments;
6. other resources of the organization; and
7. the investment policy of the organization.

The currently proposed version of UPMIFA includes a provision that the Conference of Commissioners describes as "optional," which serves as a limitation on the ability to spend endowment assets.[6] Specifically, expenditures in any year of ***more than 7% of the fair market value of an endowment fund***, determined on a quarterly basis over a period of three years, will result in a rebuttable presumption of imprudence. This applies to each endowment fund, separately. However, spending 7% or less does not conclusively mean the organization acted prudently; rather, it merely shifts the burden of establishing that the organization failed to act prudently to the complaining party, most likely the Massachusetts Attorney General. This provision of UPMIFA differs from the existing law in that it applies to expenditures in any year in excess of 7% of the value of the endowment fund, whereas existing law creates a rebuttable presumption of imprudence where expenditures of ***net appreciation*** exceed 7% of the fair market value of the fund over the same period.

Investment Decision Making

When making decisions concerning whether to make or retain an investment, delegate investment management responsibilities or accumulate income or appropriate appreciation, UMIFA requires the members of the governing board of a charitable organization to consider:

- the long and short term needs of the organization in carrying out its purposes;
- the problems peculiar to the organization;

- the present and anticipated financial requirements;
- the expected total return on its investments;
- price level trends; and
- general economic conditions.

UMIFA also provides that no member of a governing board shall have liability for any of its acts or omissions if that member has discharged his or her duty in good faith and "with that degree of diligence, care and skill which prudent men would ordinarily exercise under similar circumstances in a like position." UPMIFA reaches the same result by establishing a prudence standard for members of a governing board which, if followed, is intended to protect directors and trustees from liability.[7] UPMIFA, as proposed, requires each person responsible for managing and investing an institutional fund to manage and invest the fund "in good faith and with the care an ordinarily prudent person in like position would exercise under similar circumstances."[8]

UPMIFA clarifies UMIFA's standards relating to the management of an institutional fund by requiring the governing board to consider the purposes of the organization ***and*** the purposes of the institutional fund. UPMIFA allows an organization to incur only "costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution." It also requires an organization to make "a reasonable effort to verify facts relevant to the management and investment of the fund." In other words, the duty to conduct a diligence investigation, the duty to minimize costs, and adherence to the duty of care are explicitly mandatory under UPMIFA.

To guide the governing board of a charity in the management and investment of an institutional fund, UPMIFA provides a specified list of factors that, if relevant, "must" be considered in the exercise of prudence. In addition to considering both the purposes of the organization and the purposes of the institutional fund, the other factors that must be considered in the prudent management and investment of a fund are:

- general economic conditions;
- the possible effect of inflation or deflation;
- expected tax consequences, if any;
- the role that each investment or course of action plays within the overall investment portfolio of the fund;
- the expected total return from income and the appreciation of investments;
- other resources of the organization;
- the needs of the organization and the fund to make distributions and to preserve capital; and
- an asset's special relationship or value, if any, to the charitable purposes of the organization.

If enacted, UPMIFA will require directors and others responsible for managing and investing a charity's funds to use a modern portfolio theory approach to making investments and considering the risk and return objectives of an institutional fund.[9] Therefore, UPMIFA will mandate the diversification of an organization's investments, unless special circumstances exist that would make diversification unreasonable (for example, when a charity decides to purchase real estate or other capital asset in the near future). Within a reasonable time after receiving additional property, an organization will be required to make and implement decisions about its retention or disposition (or the rebalancing of its portfolio) in order to bring its institutional funds into compliance with the purposes, terms and distribution requirements of the organization, as necessary. Finally, if a person has special skills or expertise or is selected in reliance upon his or her representation that he or she has special skills or expertise, that person will be required to use those skills or expertise in managing and investing the charity's funds.

Delegation of Management/Investment Authority

Similar to UMIFA, UPMIFA will permit the delegation of investment functions relating to an endowment fund both to employees, officers or committees of the organization and to agents outside the organization. However, UPMIFA provides clearer guidance when delegating management and investment functions to external agents. When delegating to an external agent, the organization must act prudently when selecting the agent, establishing the terms of delegation and reviewing compliance. If it does so, the charity will not be liable for decisions or actions of an agent to whom the function was delegated. The agent must exercise reasonable care in complying with the scope and terms of the delegation, and by virtue of accepting such delegation of authority, agrees to submit itself to the jurisdiction of the courts of the Commonwealth in all proceedings arising from or related to the delegation of authority.

Donor Restrictions

Both UMIFA and UPMIFA permit a donor to release a restriction imposed on the management or investment of an institutional fund contained in a gift instrument. Under UMIFA, if such consent cannot be obtained due to the death, disability, unavailability or impossibility of identifying the donor, then the organization may petition a court to request that the restriction be lifted. UPMIFA, if enacted, expressly provides that, following notification of the Massachusetts Attorney General and upon affording her an opportunity to be heard, a court may modify a restriction when:

- it has become impracticable, wasteful, impairs the management of a fund, or if due to circumstances not anticipated by a donor, the change will further the purposes of the fund; or
- a restriction or charitable purpose in a gift instrument becomes unlawful, impracticable, impossible to achieve or wasteful.

Another interesting provision in UPMIFA would permit a charity to release or modify a donor-imposed restriction on small, older institutional funds. Sixty days after providing notice to the Massachusetts Attorney General, a charity may release or modify a donor imposed restriction where:

- the institutional fund subject to the restriction has a total value of less than $25,000;
- more than 20 years have elapsed since the fund was established;
- the organization uses the property in a manner consistent with the purposes of the gift; and
- the organization determines that the restriction is wasteful, unlawful, impracticable, or impossible to achieve.

A Critical Change in the Law Governing Endowment Funds

Charitable organizations operating in Massachusetts should take note of the proposed passage of UPMIFA, which would codify several important changes in the law impacting the investment and management of endowment funds. Enactment of UPMIFA will allow greater flexibility and discretion in making investments, in appropriating expenditures from an endowment fund, in delegating authority to internal and external parties, and in releasing gift restrictions imposed by donors. It also will provide more explicit guidance to the governing boards of these organizations in making these types of decisions. The most significant of these changes, given the current economic environment, may be the provision which would permit an organization to spend endowment principal as it deems prudent after considering several factors, including the purposes of the fund and the maintenance of its long-term purchasing power. It also would enhance the ability of a charity to manage the investment and use of endowment funds in light of both the current need and the long-term financial viability of their funds.

Endnotes

[1] These states include Illinois, Maine, Michigan, New Jersey, New York and Rhode Island.

[2] These entities are referred to as "Institutions" in UMIFA and UPMIFA. However, in this Advisory, we refer to these entities as charitable organizations except when quoting from UMIFA, UPMIFA or the Conference of Commissioners official comment to the model version of UPMIFA.

[3] Institutional funds subject to restrictions imposed by a governing board are not endowment funds because the governing body has the discretion to remove such self-imposed restrictions. The rules on expenditures and modification of restrictions under UMIFA and UPMIFA apply only to endowment funds.

[4] UMIFA permits charities to spend current income (such as interest and other current income) unless the relevant gift instrument provides otherwise. In the context of endowment fund assets, appreciation and depreciation are trust accounting terms that refer to realized and unrealized increases and decreases in fair market value.

[5] Should a governing board conclude that one or more factors are not relevant, it would be wise to make an affirmative determination to that effect and describe in the minutes of its meeting the basis for its conclusion.

[6] One person testifying at the Judiciary Committee hearing held on June 2nd urged omission of the 7% expenditure limitation provision from the bill and noted that many states did not adopt this optional provision. In the alternative, he proposed that the 7% expenditure limitation apply only to organizations with endowments valued at $2 million or less.

[7] In the official comment to the model version of UPMIFA, the Conference of Commissioners notes that the standards of prudence are intended to be consistent with the concept of the business judgment rule existing under corporate law, as applied to a charitable organization.

[8] This formulation of the standard imposed by UPMIFA is based principally on the articulation of the standard of care included in the Revised Model Nonprofit Corporation Act.

[9] We note that under UPMIFA these requirements apply to all funds held by an organization, not only endowment funds.

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