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DIVING INTO ENDOWMENTS:
UPMIFA and More

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I. WHAT IS AN ENDOWMENT?

A. To a donor, an endowment is a sum of money given to a charity for charitable purposes, with only the "income" being spent and "principal" being preserved.

B. To an accountant, it is a fund that is "permanently restricted".

C. To a lawyer, it is an institutional fund not wholly expendable on a current basis under the terms of the gift instrument.

D. Thus, a "true" endowment is one established or created by the donor. A board-restricted endowment (or "quasi-endowment") is created when the Board takes unrestricted funds and imposes a spending restriction.

II. WHAT WAS UMIFA AND WHY WAS IT ADOPTED?

The Uniform Management of Institutional Funds Act (UMIFA) is a uniform law that provides rules regarding how much of an endowment a charity can spend, for what purpose, and how the charity should invest the endowment funds. The model UMIFA was adopted by the National Conference of Commissioners on Uniform State Laws in 1972. It was adopted because charities and their lawyers were unsure how to define "income" in the context of an endowment. Many looked to trust law, which generally defines "income" as including interest, dividends and the like, but defines gains as "principal". Thus, charities invested endowments in bonds and high-dividend stocks, but passed by investments with favorable growth prospects if they had a low current yield. Consequently, long-term yield suffered. The drafters of UMIFA thought charities should be able to spend a prudent portion of the gains earned by an endowment.

III. SO WHAT IS UPMIFA?

A. UMIFA is thought to be out of date, particularly as to management, investment, and spending issues. In particular, the post-dot.com "down" market resulted in many "underwater" endowments, exposing the flaws in the UMIFA spending rules.

B. UPMIFA was approved by the National Conference of Commissioners on Uniform State Laws in July 2006, and has been adopted by approximately one-half of the states.

C. UPMIFA, when enacted, applies to both funds created after that date, and to decisions made after that date for existing endowments (i.e., it is "retroactive").

IV. HOW DOES AN ENDOWMENT GET CREATED?

A. An endowment fund is a fund not wholly expendable by the institution on a current basis under the terms of the applicable gift instrument. UPMIFA makes it clear that the term "endowment fund" does not include funds that the charity designates as endowment (these are "quasi-endowment" funds).

B. UPMIFA defines a gift instrument as being a "record" – information inscribed on a tangible medium or stored electronically – including an institutional solicitation, under which property is given. UPMIFA thus makes it clear that a gift instrument must be in writing, but expands the definition to include email. Governance documents, such as Bylaws, may be part of the gift instrument. A record is part of the gift instrument, however, only if the donor and the charity were, or should have been, aware of its terms.

V. HOW SHOULD A CHARITY INVEST ITS ENDOWMENT?

A. Investment is a matter of state law. In many states (including California), the Board is subject to the rules on prudent investments as set forth in both the Corporations Code and UPMIFA (which are often not entirely consistent).

B. The California Corporations Code provides that a Board must "avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety of funds." This is an "old fashioned" and fairly conservative statement of the prudent investor rule.

C. UPMIFA articulates a standard of care for both managing and investing an endowment. It requires the charity to consider the charitable purposes of the charity and the purposes of the endowment fund. It requires the Board (and others responsible for managing and investing) to act in good faith and with the care of an ordinary prudent person, and notes that the charity may incur only appropriate and reasonable costs. The charity must consider:

1. General economic conditions,
2. Effects of inflation and deflation,
3. Tax consequences,
4. The role of each investment in the overall portfolio,
5. Expected total return from income and appreciation,
6. The charity's other resources, and
7. The needs of the charity and the fund to make distributions and preserve capital.

D. UPMIFA provides that an individual investment must be analyzed in the context of the total portfolio and the overall risk-reward objectives, and that a charity can invest in any kind of property that is not inconsistent with the standard of care.

E. UPMIFA imposes a duty to diversify.

VI. HOW MUCH OF AN ENDOWMENT CAN A CHARITY SPEND?

A. UMIFA provided that "The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, both realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent ...."

Historic dollar value is "the aggregate fair value in dollars of (1) an endowment fund at the time it became an endowment fund, (2) each subsequent donation to the endowment fund at the time it is made, and (3) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the endowment fund."

Although UMIFA did not explicitly so state, most attorneys concluded that "income" (e.g., interest and dividends) could be spent as well (even with an "underwater" endowment).

B. UPMIFA makes a radical change and does away with the concept of "historic dollar value". UPMIFA allows a charity to appropriate for expenditure, or accumulate, so much of an endowment fund as the charity determines is prudent for the purposes for which the fund was established.

The charity must consider:

1. The duration and preservation of the endowment fund,
2. The purposes of the charity and the fund,
3. General economic conditions,
4. Effects of inflation and deflation,
5. Expected total return from income and appreciation,
6. The charity's other resources, and
7. The charity's investment policy.

C. The model UPMIFA includes an optional provision stating that an appropriation of greater than 7% of the average FMV of an endowment (averaged over the last three years) is be presumptively imprudent.

VII. WHAT ABOUT DELEGATION?

UPMIFA allows a charity to delegate management and/or investment decisions to agents. The charity must act prudently in selecting the agent, establishing the scope of the delegation, and reviewing the agent's actions. A charity that does so is not liable for the actions of the agent. However, the agent is held to a "reasonable care" standard and is expressly made subject to appropriate court jurisdiction.

VIII. WHAT ABOUT CHANGING A RESTRICTION?

A. UPMIFA allows a charity to release or modify a restriction regarding management, investment, or purpose of a fund if the donor consents in writing.

B. If a purpose or use restriction becomes unlawful, impracticable, impossible to achieve, or wasteful, the court may modify the restriction in a manner consistent with the donor's intent. The Attorney General must be notified.

C. The court can modify a management or investment restriction if it has become impracticable or wasteful, impairs the management or investment of the fund, or (if due to unforeseen circumstances) the release would further the purposes of the fund. The Attorney General must be notified.

D. If a fund is less than $25,000 ($100,000 in California!) in value and over 20 years old, and the charity determines that a restriction on the management, investment, or use of the fund is unlawful, impracticable, impossible to achieve, or wasteful, the charity can (after notice to the Attorney General and the donor) release or modify the restriction. It must thereafter use the funds in a manner consistent with the donor's charitable purposes.

IX. WHAT ABOUT ENFORCING SPENDING OR PURPOSE RESTRICTIONS?

A. The Attorney General can bring and action to enforce the terms of a restricted gift. Depending on the law governing the internal affairs of the charity, an officer, director, or even a voting member may be able to challenge a breach of trust. *See, e.g.,* Cal. Corp. Code §5142 (for California nonprofit public benefit corporations).

B. What if the donor believes the institution is violating the use restriction? Some states have held that unless the donor reserves a right to enforce in the gift instrument, only the state Attorney General has legal standing (*Carl Herzog Foundation v. University of Bridgeport*, 699 A.2d 995 (1997)). Other states have concluded that a donor may have standing (*LB Research and Education Foundation v. UCLA Foundation*, 130 CalApp 4th 171 (2005)*; Smithers v. St. Luke's Roosevelt Hospital Center*, 723 N.Y.S.2d 426 (2001)).

C. A donor may consider building donor standing into the gift instrument. A power of reversion is likely to render the gift incomplete and non-deductible for income tax purposes; consider including a power to redirect the gift to another charity willing to abide by the restrictions in the event of default.

X. WHAT ABOUT THOSE ACCOUNTANTS?

A. In general, 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.

B. FASB Staff Position 117-1 sets forth proposed guidelines for reporting endowments governed by UPMIFA. It states that a charity should classify "all or a portion" of an endowment as permanently restricted net assets, based upon explicit donor restrictions (if any) or what the Board determines must retained permanently. For example, a Board could determine that UPMIFA requires it to maintain the "historic dollar value" of its endowments. The value of an endowment in excess of the amount reported as permanently restricted is to be reported as temporarily restricted, until such time as some amount is "appropriated for expenditure", at which time that amount becomes unrestricted. FASB Staff is not encouraging charities to report as permanently restricted the purchasing power of an endowment (e.g., initial value increased by the rate of inflation, not reduced for losses or expenditures). Staff Position 117-1 also requires more disclosure, including information regarding a charity's spending policy and investment policy.

C. FASB 124 requires that distributions from the endowment, and losses suffered by the endowment, be taken first from the temporarily restricted asset class, then from the unrestricted asset class. Put another way, the amount reported as permanently restricted funds would not change if there is a significant investment loss; the loss would reduce the temporarily and unrestricted asset classes.

XI. WHAT ALTERNATIVES DO WE HAVE FOR "RELUCTANT" DONORS?

A. **Virtual Endowment –** for the donor with high cashflow, but not a lot of available liquid assets. Essentially a pledge of an annual gift for life and a large bequest. View the annual gift as the income payment from the endowment principal, which is "held" by the donor for life and given to charity at death. (Credit due to William Samers, UJA Federation of New York).

B. **Amortized Endowment** – for the donor with high cashflow, but not a lot of available liquid assets. Essentially a mortgage – donor does a term pledge for an annual amount that consists (like a mortgage) of an income component (spendable by the charity) and a principal component (that the charity retains). At the end of the term, the accumulated "principal" payments constitute the donor's endowment balance. (Credit due to William Samers, UJA Federation of New York.)

C. **Revocable Endowment –** for the donor who can afford to "give up" the principal now, but is worried about the future. Essentially a reversionary grantor CLT – charity gets the annual payments for a term of years, and donor gets the funds back at termination. Donor can then either keep the principal, or give it to charity again. As discussed in Journal of Gift Planning article "The Lemonade Solution" (4th Qtr 2004), this can have additional benefits if the CLT is funded with "undervalued" stock. (Credit due to Lynn McDowell.)