UMIFA AND UPMIFA:
The Law of Endowments

ABA - Taxation and Real Property, Trust and Estate Law Sections

September 12, 2008

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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 which 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 IS UMIFA AND WHY WAS IT ADOPTED?

The Uniform Management of Institutional Funds Act (UMIFA) is a uniform law which provides rules regarding how much of an endowment a charity can spend, for what purpose, and how the charity should invest the endowment funds. UMIFA was proposed 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 AND WILL IT BE ADOPTED?

A. UMIFA is thought to be out of date, particularly as to management, investment, and spending issues.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 in approximately half of the states (as of August 2008).

C. Senate Bill 1329 has been introduced to bring UPMIFA to California. It is sponsored by the Association of Independent California Colleges and Universities (AICCU), and was introduced by Senator Harman. If it is enacted, it will apply to funds created before and after the date of passage.

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. UMIFA defined a gift instrument is "a will, deed, grant, conveyance, agreement, memorandum, writing, or other governing document (including the terms of any institutional solicitations from which an institutional fund resulted)...."

C. 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 California, the Board is subject to the rules on prudent investments as set forth in both the Corporations Code and UMIFA (which unfortunately are not entirely consistent).

B. The Corporations Code provides that in making investments, 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. UMIFA articulates the modern portfolio theory of prudent investment. It provides that the Board may invest in real or personal property mortgages, deeds of trust, stocks, bonds, debentures, and other securities. It may participate in a pooled income fund, mutual fund, or other forms of common funds.

D. UMIFA also provides a standard of care in investing, which is comparable to the modern prudent investor rule:

> When investing . . . and delegating investment management for the benefit of an institution, the members of the governing board shall act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the institution. In the course of administering the fund pursuant to this standard, individual investments shall be considered as part of an overall investment strategy.

> In exercising judgment under this section, the members of the governing board shall consider the long- and short-term needs of the institution in carrying out its . . . purposes, its present and anticipated financial requirements, expected total return on its investments, general economic conditions, the appropriateness of a reasonable proportion of higher risk investment with respect to institutional funds as a whole, income, growth, and long-term net appreciation, as well as the probable safety of funds.

E. UPMIFA also articulates a general 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.

F. 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.

G. UPMIFA imposes a duty to diversify.

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

A. UMIFA provides 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 …."

Net appreciation includes realized gains and unrealized gains.

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 does not explicitly so state, "income" (e.g., interest and dividends) may be spent as well.

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 that 7% of the average FMV of an endowment (averaged over at least the last three years) is be presumptively imprudent. As originally proposed, SB 1329 did *not* include this provision - however, it has since been added to the final bill (excluding educational institutions and their foundations).

VII. WHAT ABOUT DELEGATION?

A. UMIFA allows a board to delegate investment decisions to committees, officers, employees, or third-party agents.

B. UPMIFA has an expanded delegation section. It allows a board to delegate both management and investment decisions to committees, officers, employees, and agents. As to delegating to an "external agent", 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. Under UPMIFA, with written consent of the donor, a charity may release a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund. If a donor is not available, by reason of death, disability, etc., the charity may petition the Probate Court for release of a restriction. If the court finds that the restriction is *obsolete or impracticable*, it may release the restriction, but may not change an endowment fund to a fund that is not an endowment fund.

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

C. If a purpose or 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.

D. 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.

E. If a fund is less than $100,000 in value and over 20 years old, and the charity determines that a restriction is unlawful, impracticable, impossible to achieve, or wasteful, the charity can (after notice to the Attorney General) 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 an 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 does have standing (*LB Research and Education Foundation v. UCLA Foundation*, (June 15, 2005 decision of California Court of Appeals)*; 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, but a power to redirect the gift to another charity willing to abide by the restrictions may give the donor standing without jeopardizing the deduction.

X. WHAT ABOUT THOSE ACCOUNTANTS?

A. 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 124 requires that distributions from the endowment, and losses suffered by the endowment, shall not reduce the amount reported as "permanently restricted". Put another way, the reported value of the "true" endowment (or "permanently restricted" funds) remains at the sum of the value of the gifts/bequests on the dates of transfer (under UMIFA); all gains, losses, income, distributions, etc. impact the unrestricted asset class.

C. FASB Staff Position 117-1 sets forth 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 purchasing power of an endowment (e.g., initial value increased by the rate of inflation, not reduced for losses or expenditures). The remaining balance of the endowment fund is to be reported as "temporarily restricted" until appropriated for expenditure. It also requires more disclosure, including information regarding a charity's spending policy and investment policy.