Endowment Spending – What's a University to Do?

Should Brandeis University sell off its art collection to meet expenses? Why can't it use its endowment instead? What if the endowments used to fund professorships or scholarships drop in value? Should a university spend more from its endowment to tide it over during these difficult economic times? Should a university spend less and try to preserve what's left in its endowment?

These are all pressing questions, but none of them have easy answers. Legal rules provide guidance - not answers - but understanding the guidance is instructive. Misunderstandings about what the laws say – and do not say - have confused the discussions about endowment spending. A clearer understanding may help.

A number of incorrect statements have circulated recently:

- A university or other charity cannot spend from an endowment fund that is "underwater" (i.e., with a value below the value of the original gift).
- UMIFA was created to protect money in endowment funds; UPMIFA allows charities to spend whatever they want.
- UPMIFA changes donor intent.

A bit of history will help explain why these statements are not accurate.

Two versions of a state law apply to many endowment funds. UMIFA (the Uniform Management of Institutional Funds Act (1972)) is the older version, adopted in 47 states and the District of Columbia, and UPMIFA (the Uniform Prudent Management of Institutional Funds Act (2006)), is the newer version, adopted in 28 states plus DC and under consideration in many more states. Both statutes apply to charities organized as nonprofit corporations, and in most states the statutes apply to colleges and universities or, in the case of public universities, to the endowment funds held for them by university foundations.

UMIFA and UPMIFA both provide interpretations of donor intent concerning spending from endowment funds. The statutes apply only when a university and donor have not reached some other agreement about the "rules" that will govern endowment spending. Many endowment funds need not use the statutory guidance.

Imagine that a university says to a donor, "Here's how we operate the endowment – we apply a spending rate of four percent to the total value of the fund and that's what we distribute each year. We review the spending rate every year and we may adjust it up or down, but we won't make huge adjustments." The donor responds, "Great. That sounds like a good way to operate. Here's $100,000 for the endowment." (Would that it were always that easy.) In this case, assuming that the information is written down by the university and given to

the donor, UMIFA (or UPMIFA) will not apply – the university and donor have written their own rules.

But what if a donor makes a gift to a university and says, “hold this as an endowment” or maybe instead says, “spend only the income from this gift.” If income had one, clear definition, we would know what that donor meant, but income may mean trust accounting income (the rules that determine income and principal for a trust), taxable income, corporate income, or something else. In the 1960s, most people assumed that “income” for a university meant trust accounting income. The trust accounting rules defined income as interest, dividends, rents, and royalties and assigned all capital gains to principal. An endowment that could only distribute “income” might be tempted to invest primarily in bonds to generate interest. A decision not to invest in stocks meant more income in the short term, but also meant that the value of the fund eroded over time.

In 1972 the Uniform Law Commission (aka the National Conference of Commissioners on Uniform State Laws) produced UMIFA to respond to the problem. UMIFA did not define income or principal and left a lot of open questions, but it did make investing for total return possible and enabled charities to create balanced portfolios for their endowments. UMIFA facilitated the successful growth of many endowments. It also indirectly encouraged the development of the spending rates that many universities and other charities now use.

UMIFA created a concept called historic dollar value (“hdv”), to represent the dollars contributed to an endowment. Hdv did not represent “principal” and UMIFA did not suggest that a fund should spend everything above hdv. The concept simply provided a way to say that a charity could spend appreciation - the amount above hdv – and thus authorized the spending of capital gains. An endowment fund is said to be “underwater” when the value of the fund falls below its hdv. A fund cannot spend capital gains while it is underwater. UMIFA said nothing about when a charity could spend interest and dividend income, and the right to spend that income appears to continue under other law, even when a fund is underwater.

UMIFA worked reasonably well, but using hdv as a way to explain spending created some odd results. For an old fund, hdv becomes meaningless. An endowment created in 1930 with $100,000 might be worth $1 million in 2009. An hdv of $100,000 does not provide any useful guidance on what the endowment should spend. For a recently established fund, hdv may prevent the university from spending capital gains, if a drop in stock market follows soon after the gift. An endowment created in 2007 with $100,000 may be worth $70,000 or even less in 2009. The hdv remains at $100,000, and the university will be unable to spend appreciation until the value of the fund exceeds that amount.

UPMIFA changes the guidance for charities trying to do right by their donors. UPMIFA does not (and could not, constitutionally) change donor intent. Rather UPMIFA changes the way a university interprets donor intent.

As discussed, when a donor says "pay only the income," the donor has not clearly indicated what that means. Before UMIFA, universities interpreted it to mean "pay only interest and dividend income." UMIFA then changed the interpretation and interpreted it to mean "spend the amount of appreciation above hdv that the university determines to be prudent." UPMIFA changes the interpretation again and interprets the donor to mean "spend some amount each year but hold enough back to preserve the long-term viability of the fund." Both UMIFA and UPMIFA require the university to act prudently in deciding how much to spend, but UPMIFA provides more and better guidance for making that determination.

Here again are those incorrect statements, this time followed by explanations of why the statements are incorrect.

- Under UMIFA, a university cannot spend from an endowment fund that is "underwater."

UMIFA does not prevent a university from spending interest or dividend income earned by an underwater endowment. Guidance on the website of the New York Attorney General's Charities Bureau takes this position, and this position is consistent with the language of UMIFA.

A university may also be able to spend from an underwater endowment if the university authorized the spending before the fund went underwater. UMIFA and UPMIFA both use the language "appropriate for expenditure" rather than "spend." The distinction is intentional. The board of a university will typically make a decision to spend from an endowment at some time, perhaps some months, before the actual spending takes place. The board must be able to act based on information available at the time the board makes the decision. If a decision to spend is prudent at the time the board votes to appropriate, then the university can spend that amount even if the endowment goes underwater after the appropriation.

- UMIFA was created to protect money in endowment funds; UPMIFA allows charities to spend whatever they want.

John Hechinger and Jennifer Levitz discussed endowments in the Wall Street Journal (Feb. 11, 2009) and described UMIFA as "laws passed decades ago to keep charitable gifts from disappearing too rapidly . . . ." As explained above, UMIFA actually increased the ability of a university to spend from an endowment fund by authorizing the spending of capital gains. Hdv was not

created to protect the funds of an endowment; hdv was created to provide a mechanism for determining what constituted appreciation.

UPMIFA provides better guidance on spending from an endowment and establishes more clearly the rules of prudence that govern that spending. For old funds, hdv is meaningless, and although UMIFA requires the university to be prudent, UPMIFA provides a list of factors for the university to consider in making a prudent decision. The duration of the fund is key among those factors and reminds the university not to spend too much or too quickly. UPMIFA permits spending when a fund's value falls below hdv, but only if spending under those circumstances is prudent, keeping in mind the long-term nature of an endowment fund.

- UPMIFA changes donor intent.

Neither UMIFA nor UPMIFA change donor intent, although both change the interpretation of what an endowment means. When UMIFA first appeared, the New Hampshire Legislature asked the New Hampshire Supreme Court whether UMIFA would violate the contracts clause of the constitution if it applied to gifts that pre-dated the statute. The court concluded it would not, because the statute merely interprets intent and does not change it. Like UMIFA, UPMIFA changes the interpretation of what it means to be an endowment.

Anecdotal evidence suggests that many donors want an endowment to continue spending during economic downturns. Continuation of a university's programs is more important to these donors then maintenance of any particular amount in the fund. But donors presumably also hope that the university will weather current conditions and will have enough left in its endowment to continue to grow and build.

UPMIFA allows a university to spend appreciation when a fund goes underwater, and for that reason interest in UPMIFA has grown. Under UPMIFA a university will not need to change its investment strategy to generate interest and dividend income in order to continue spending, and a university can use its endowments sensibly during these difficult economic times. But UPMIFA will not solve a university's economic woes and still leaves the university with hard decisions. One university may find spending from an endowment necessary to continue funding important programs. As long as the university complies with any purpose restrictions on the endowment, spending may be prudent, even if the value of the fund drops further. Another university may have enough other funds to manage in the short-term, and may decide to reduce or limit spending from the endowment, to preserve the amount that remains until the market recovers. Either decision may be correct legally, and the board must decide which is better for the university. UPMIFA improves the law, both by providing flexibility to universities to allow them to make good decisions and by providing better guidance about what it means to be "prudent."

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