

State of the States

By Douglas A. Pessefall and Joseph A. Pickart

UPMIFA Expands

Over the last few years, 42 states have enacted the Uniform Prudent Management of Institutional Funds Act (UPMIFA), approved in 2006 by the National Conference of Commissioners on Uniform State Laws (“Commission”).¹ In a nutshell, UPMIFA imposes standards governing the management, investment and spending of institutional funds and endowments held by charitable organizations, and is intended to be the successor model statute to the Commission’s 1972 Uniform Management of Institutional Funds Act (UMIFA), which had served as the primary law governing those funds in 47 states and the District of Columbia.²

The Commission introduced UPMIFA as a necessary update to UMIFA by incorporating many of the post-UMIFA trust law developments and as a way to give fund managers more flexibility in managing and investing charitable assets. UMIFA itself was an effort to reduce the restrictions on investment decision-making that were inherent in general trust law that provided guidance and standards prior to the adoption of UMIFA.³

While UPMIFA has been widely promoted and publicized by some commentators as a state legislative “fix” in today’s economy to allow organizations to spend money from underwater endowments—those endowments with values that have dropped below their historic dollar value—UPMIFA’s reach and impact extends well beyond endowments. This article summarizes the scope of UPMIFA by describing how UPMIFA establishes standards of conduct for (1) the management and investment of institutional funds; (2) the expenditure and accumulation of endowments; (3) the delegation of fund management and investment authority; and (4) the release or modification of restrictions contained in a gift instrument on the management, investment or purpose of an institutional fund. Even so,



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UPMIFA emphasizes that those standards of conduct are generally secondary to and subject to the intent of a donor as expressed in a gift instrument. The article concludes by offering some general recommendations to organizations that hold institutional funds and to the practitioners who represent them.

Management and Investment of Institutional Funds

UPMIFA applies to the management and investment of “institutional funds,” which includes any fund (but not a program-related asset) that is held by a charitable organization exclusively for a charitable purpose.⁴ A “charitable purpose” includes the relief of poverty, advancement of education or religion, promotion of health, promotion of a governmental purpose, or any other purpose the achievement of which is beneficial to the community.⁵ Accordingly, the scope of UPMIFA clearly extends beyond the endowments (defined below as a type of institutional fund) and potentially encompasses the funds held by many nonprofit organizations.

With respect to institutional funds, UPMIFA adopts a prudent investor standard, along with the existing business judgment standards under corporate law as applicable to nonprofit corporations (including the duties of loyalty and care),⁶ to govern investment decision-making and extends those standards to anyone who invests and manages institutional funds, including directors, officers, managers, employees and agents.⁷ The UPMIFA prudent investor standard replaces the UMIFA standard of “ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision.”⁸

The prudent investor standard requires that institutional funds be managed and invested in a manner that considers the following factors:

- general economic conditions;
- the possible effect of inflation or deflation;
- the expected tax consequences, if any, of investment decisions or strategies;
- 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 institution;
- the needs of the institution and the fund to make distributions and to preserve capital; and
- an assets special relationship or special value, if any, to the charitable purposes of the institution.⁹

These factors form a sort of pre-investment due diligence checklist, and require that investment and management decisions consider the institution’s entire portfolio of investments (not just individual assets) and risk and return objectives that are reasonably suited to the institution;¹⁰ incur only those costs that are appropriate and reasonable;¹¹ diversify investments;¹² identify and retain or dispose of unsuitable assets or rebalance portfolios.¹³

Expenditure and Accumulation of Endowments

UPMIFA also applies to “endowments,” which are institutional funds that, under the terms of a gift instrument, are not wholly expendable on a current basis by the institution (as distinguished from board-designated restricted funds).¹⁴ In turn, UPMIFA broadly defines a “gift instrument” to mean any record, including written directions or restrictions by the donor or even the institution’s own articles of incorporation, bylaws, minutes of the board of directors, cancelled checks or solicitation materials.¹⁵ In other words, any writing or collection of writings that impose terms with respect to the use of gifted funds, and that reflects an awareness of restrictions on the part donor and the institution, may create an endowment subject to UPMIFA.

With respect to endowments, UPMIFA applies a prudence standard to the expenditure and accumulation of endowment funds, and allows institutions to spend or accumulate so much of an endowment as is prudent for the uses, benefits, purposes and duration for which the endowment was established.¹⁶ In so doing, UPMIFA requires persons who make endowment spending decisions to focus on the purposes of the endowment rather than on the purposes of the institution.¹⁷ The UPMIFA prudence standard replaces the UMIFA restrictions on the expenditure of an endowment only to the amount of the endowment’s income or appreciation in value over its historic dollar value.¹⁸

The prudence standard requires that institutions consider the following factors before making a decision to expend or accumulate funds in an endowment:

- 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 of the institution.¹⁹

UPMIFA also provides states with optional language to create a rebuttable presumption of imprudence when an institution spends more than seven percent of an endowment's fair market value (though the Commission commented that there is no corresponding presumption of prudence if the expenditure is less than 7 percent of the endowment's fair market value).²⁰ About 30 percent of the states adopting UPMIFA have included language to create a presumption of imprudence ranging from five to seven percent and, in some cases, applying only to endowments with an aggregate value in excess of \$1 million.²¹

UPMIFA's prudence standard for endowments has been widely publicized and came at a fortuitous time for many institutions that saw the value of their endowments drop precipitously in the current economic climate—in some cases, far below the endowments' historic dollar value (“underwater endowments”). For example, according to a study by the National Association of College and University Business Officers, college and university endowments reported an average 23 percent decline in value in the five months ending November 30, 2008.²² But, the jury is still out on whether, and to what extent, UPMIFA's prudence standard will allow institutions to tap underwater endowments. The Commission notes, for example, that the deletion of the historic dollar value standard “does not transform any portion of an endowment fund into unrestricted assets from a legal standpoint.”²³ That is because, by definition, an endowment is restricted in accordance with the donor's intent and is not expendable on a current basis.²⁴ UPMIFA does not trump the terms of the applicable gift instrument.

Delegation of Fund Management and Investment

UPMIFA also includes optional language to allow an institution to delegate to a third party or external agent the management and investment of an institutional fund to the extent that the institution can do so prudently.²⁵ Specifically, in delegating the management and investment of an institutional fund, the institution is required to:

- select an agent;
- establish the scope and terms of the delegation, consistent with the terms of the institution and institutional fund; and

- periodically review the agent's actions in order to monitor the agent's performance and compliance with the scope and terms of the delegation.²⁶

An agent is charged with the duty to the institution to exercise reasonable care in complying with the scope and terms of the delegation, and, by accepting the delegation, submits to the jurisdiction of the state in all proceedings arising from its performance of the delegated function.²⁷ To the extent that an institution complies with the prudence standard in delegating its authority, the institution is not liable for the decisions or actions of an agent to whom it delegated its authority.²⁸

Release or Modification of Restrictions

UPMIFA also expands an institution's ability to release or modify restrictions contained in a gift instrument on the management, investment or purpose of an institutional fund; provided, however, that any release or modification may not allow a fund to be used for purposes other than the institution's charitable purposes.²⁹ Specifically, UPMIFA provides that restrictions may be released or modified with the consent of the donor, the courts and, in limited cases, by the institution itself. This latter method is new to UPMIFA, and allows an institution (with 60-day advance notice to the state attorney general) to release or modify restrictions on an institutional fund with a value that is less than a threshold amount (UPMIFA suggests \$25,000) and that has been in existence for a specified number of years (UPMIFA suggests 20 years), provided that the institution uses the property in a manner that is consistent with the charitable purposes expressed in the gift instrument.³⁰

Summary and Recommendations

In summary, UPMIFA is a default statute that requires a charitable organization's directors, officers, employees and agents to act prudently in managing, investing and spending any charitable funds held by the organization and, as a default statute, applies only in the absence of contrary instructions in a gift instrument. UPMIFA identifies specific factors that must be considered by directors and, in some cases, sets presumptions of imprudence. So, while UPMIFA arguably increases a director's flexibility in managing, investing and spending charitable funds, UPMIFA also increases

the director's responsibility and accountability for the use of those funds.

- Know the law. UPMIFA is model statutory language that may be modified upon adoption by any given state. Moreover, UPMIFA represents new law that is open to interpretation by the courts.
- Identify and categorize all of the organization's funds and assets, including unrestricted institutional funds, endowments (a type of institutional fund), board-designated restricted funds, and program-related assets. Of the listed asset types, only the institutional funds (including endowments) fall within the UPMIFA statutory scheme.
- Review the gift instrument applicable to each donor-restricted fund. Notwithstanding all of the media hoopla surrounding the adoption of UPMIFA, the gift instrument and donor intention control the use of the funds.

- Educate the board of directors. Directors should become familiar with the institutional and endowment funds held by the organization (and any restrictions on their use), UPMIFA and its prudence standards, the types of assets to which UPMIFA applies, and when and to whom the board of directors can delegate its fund management and investment functions.
- Develop a written institutional funds use policy. The policy should apply the prudence standards enumerated herein in connection; require documentation of the organization's pre-investment due diligence; require continuous monitoring and periodic evaluation of the management and investment of the organization's funds; and require approval by the board of directors prior to managing, investing or expenditure of institutional funds.
- Record and document approval by the board of directors.

ENDNOTES

¹ Nat'l Conference of Comm'rs on Unif. State Laws, Enactment Status Map, available at www.upmifa.org/DesktopDefault.aspx?tabindex=5&tabid=68 (last visited Sept. 1, 2009). Legislation is pending in Alaska, Kentucky, Michigan, Mississippi, New York and Rhode Island. No legislation is pending in Florida, Louisiana or Pennsylvania.

² Unif. Prudent Mgmt. of Inst. Funds Act (2006).

³ Susan Gray, *UMIFA Becomes UPMIFA*, A.B.A. PROP. & PROB. J., Jan./Feb. 2007.

⁴ UPMIFA § 2 (2006).

⁵ *Id.* §2(1).

⁶ *Id.* §3 cmt.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.* §3(e)(1).

¹⁰ *Id.* §3(e)(2).

¹¹ *Id.* §3(c).

¹² *Id.* §3(e)(4).

¹³ *Id.* §3(e)(5).

¹⁴ *Id.* §2. The fun does not stop with UPMIFA, however. In August 2008, the Financial Accounting Standards Board issued guidance titled "Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of Uniform Prudent

Management of Funds Act, and Enhanced Disclosures for All Endowment Funds," or FAS 117-1 for short. FAS 117-1 was effective December 15, 2008 and was intended to accomplish two goals: (1) provide guidance on the net asset classification of endowments in those states that have adopted UPMIFA; and (2) require new disclosures by all endowments, regardless of whether the endowment is donor-restricted or board-designated and regardless of whether the state adopted UPMIFA. The new disclosure requirements under FAS 117-1 apply to all nonprofit organizations with endowments and require organizations to disclose (a) a description of the governing board's interpretation of the law(s) that underlies the organization's net asset classification of donor-restricted endowment funds; (b) a description of the organization's endowment spending policy(ies); (c) a description of the organization's endowment investment policy(ies); (d) the composition of the organization's endowment by net asset class at the end of the period, in total and by type of endowment fund (donor restricted versus board-designated endowment funds; and (e) a reconciliation of the beginning and ending balance of the endowment, in total and by net asset class.

¹⁵ UPMIFA §2 cmt. (2006).

¹⁶ *Id.* §3(e)(6).

¹⁷ *Id.* §4 cmt.

¹⁸ *Id.*

¹⁹ *Id.* §4(a).

²⁰ *Id.* §4(d). UPMIFA provides that the market value of the endowment is to be determined quarterly and averaged over a period of not less than three years immediately preceding the year in which the expenditure is made or, if less than three years, the life of the endowment.

²¹ Cynthia R. Rowland, *UPMIFA, Three Years Later: What's a Prudent Director to Do?* A.B.A. BUSINESS LAW TODAY, Jul./Aug. 2009.

²² Katie Zezima, *Data Show College Endowments Loss Is Worst Drop Since '70s*, N.Y. TIMES, Jan. 27, 2009.

²³ UPMIFA §4 cmt. (2006).

²⁴ *Id.* §2(2).

²⁵ *Id.* §5(a). An institution may also delegate its management and investment functions to committees, officers or employees. *Id.* §5(e).

²⁶ *Id.* § 5(a).

²⁷ *Id.* § 5(b) and (d).

²⁸ *Id.* § 5(c).

²⁹ *Id.* § 6(a).

³⁰ *Id.* § 6(d).

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