

TOPIC:

UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT

INTRODUCTION:

Until recently, most college and university institutional funds have been subject to the terms of the Uniform Management of Institutional Funds Act (UMIFA), which was promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1972 and subsequently adopted in 47 states. In July 2006, NCCUSL promulgated The Uniform Prudent Management of Institutional Funds Act (UPMIFA) to update and replace UMIFA. UPMIFA has now been adopted in 25 states and the District of Columbia. Consequently, institutional funds, including endowment funds, in nearly every state are subject to the terms of either UPMIFA or UMIFA.

Under UPMIFA, "institutional funds" are funds held by the institution exclusively for charitable purposes. "Endowment funds" are institutional funds or parts thereof that, under the terms of a gift instrument, are not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment fund for its own use.

The text of UPMIFA as promulgated by the NCCUSL is attached as Appendix I. Definitional aspects are discussed in Appendix II.

UPMIFA's elimination of the "historic dollar value" floor that limits endowment spending has raised concern that some institutions might overspend. In contrast, the US Senate Finance Committee has recently questioned whether colleges with larger endowments are spending enough from their endowments to support students with financial need. This NACUANOTE will discuss the elimination of the historic dollar value concept as well as UPMIFA's other key provisions of interest to colleges and universities.

DISCUSSION:

I. The Need to Modernize UMIFA

UMIFA initiated the concept of total return expenditure of endowment assets for charitable purposes. Under UMIFA, traditional trust accounting income, augmented by a prudent amount of realized and unrealized appreciation, may be earmarked for expenditure; however, UMIFA prohibits spending below a fund's historic dollar value [1]. Historic dollar value, sometimes referred to as book value, is defined as the aggregate fair value in dollars of an endowment fund at its creation plus the value of each subsequent donation and each accumulation reinvested in endowment principal [2]. The historic dollar value limit is applied to each individual endowment fund, rather than to the institution's entire endowment in the aggregate.

The concept of historic dollar value has proved cumbersome. If a new endowment is created during a downturn in the investment markets thereby decreasing the endowment's value, the new endowment immediately becomes an "underwater" fund that is below its historic dollar value, limiting expenditure for its intended charitable purposes. In contrast, a similar endowment created earlier, preceding periods of investment growth, experiences no such limitation. The differentiation not only seems arbitrary but also creates difficult administrative problems for charitable institutions with uniform endowment spending policies.

With the passage of more than 30 years since the promulgation of UMIFA, a number of additional factors argued that an update was necessary. For example, in 1994, the Uniform Prudent Investor Act was promulgated by NCCUSL; however, by its terms, the Uniform Prudent Investor Act is a trust law statute only. While drafting committee comments to the Uniform Prudent Investor Act suggest its standards should guide charities organized as nonprofit corporations, the Uniform Prudent Investor Act does not explicitly govern nonprofit entities having a corporate structure [3].

II. Endowment Expenditure Rules

Statutory Standards. UPMIFA eliminates UMIFA's historic dollar value endowment spending limitation [4]. The new statutory standards found in section 4 of UPMIFA provide more discretion to permit good faith decisions aimed at ensuring that an endowment fund's value endures, considering the effect of inflation or deflation, while still providing prudent amounts toward expenditure for the purposes of the endowment. Attention is required to the purposes of the institution and the endowment fund, economic conditions and present and reasonably anticipated resources of the institution [5].

PRACTICE TIP: Many colleges and universities determine an endowment's expenditure by multiplying a uniform spending rate by the endowment's average value, computed by averaging recent calendar quarterly values. For example, a spending policy may provide for a distribution of 5% per annum

of the endowment's average value determined over the past 12 calendar quarters. Consider expanding the number of quarters used in computing the endowment's average value, perhaps to as many as 28 trailing quarters (7 years). Doing so will reduce volatility in the stream of endowment distributions and better facilitate budgeting and planning.

Donor Directives. The UPMIFA spending rules are inapplicable if so directed by the donor. The donor may override the statutory rules. However, the donor's mere reference in the gift instrument to use only income, interest, or dividends, "to preserve the principal intact," or similar words are inadequate to limit the authority of the institution to appropriate expenditures from an endowment fund under the standards set forth by Section 4 of UPMIFA [6].

PRACTICE TIP: To insure complete alignment of the gift instrument terms with institutional policy, it is recommended that language such as the following be included in a gift agreement or other gift instrument:

"The Fund constitutes a gift for endowment, and distributions shall be made in accordance with the institution's then existing endowment distribution policy."

Retroactive Effect. UPMIFA applies to all endowments and other institutional funds, having a retroactive application to already existing funds [7]. The UPMIFA drafting committee was concerned that applying new statutory rules only to institutional funds created after the effective date of UPMIFA's enactment, thereby retaining the historic dollar value requirement for already existing endowment funds, would require institutions to create multiple accounting systems for the same endowment fund. For example, unless UPMIFA has retroactive effect, an institution managing an already existing endowed scholarship fund under UMIFA rules would be required to create a new, segregated fund to hold post-enactment contributions to which UPMIFA would apply. The existing fund would be subject to the historic dollar value rule while the newly created segregated fund, holding post-enactment contributions, would not. Managing dual sets of endowment funds would add an administrative burden and might even affect investment decisions because of the application of the historic dollar value requirement to only one of the two components of the endowment.

Financial Statement Reporting. Elimination of the historic dollar value restriction has raised the possibility that endowment funds should be characterized as unrestricted or temporarily restricted funds for financial statement report purposes. Since there is no absolute prohibition against expending principal, as was previously the case with the historic dollar value rule, arguably the entire endowment is unrestricted. Concerned with the effect of removing the historic dollar value restriction upon financial statement reporting, the drafting committee comments that "[r]egardless of the treatment of endowment funds from an accounting standpoint, legally an endowment fund should not be considered unrestricted." UPMIFA itself instructs that "...the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution," with

only the amount appropriated for expenditure then being considered unrestricted [\[8\]](#).

On August 6, 2008, the Financial Account Standards Board (FASB) issued a staff position, FSP 117-1, addressing UPMIFA and endowments [\[9\]](#). The National Association of College and University Business Officers (NACUBO) thereafter issued a bulletin outlining highlights and discussing FSP 117-1 [\[10\]](#).

Optional Rebuttable Presumption of Imprudence - the 7% Solution. The removal of the hard and fast historic dollar value spending limitation imposed by UMIFA led a number of state attorneys general to raise concern. Fearing that less experienced charities may overspend, notwithstanding the standard of prudence and statutory guidelines, several state attorneys general, including those in New York and California, initially indicated opposition to UPMIFA without greater expenditure safeguards. As a result, an optional subsection (d) was added to Section 4 that would, if enacted, create a rebuttal presumption of imprudence if an institution expends more than 7% of an endowment's fair market value. For purposes of the rebuttal presumption, the expenditure calculation would be based on market values determined at least quarterly and averaged over a period including at least the immediately preceding three years. The drafting committee underscores that the selection of 7% is not a safe harbor, and that, under some market and economic conditions, expenditures of greater than 7% may be appropriate.

As of this writing, twenty-four states and the District of Columbia have enacted UPMIFA. Of these, eighteen have not included the optional 7% solution (Alabama, Arizona, Connecticut, Colorado, Delaware, District of Columbia, Georgia, Idaho, Indiana, Iowa, Kansas, Minnesota, Nebraska, Oklahoma, South Carolina, South Dakota, Virginia and West Virginia) while seven states have included the statutory 7% solution (Montana, Nevada, New Hampshire, Oregon, Tennessee, Texas and Utah) [\[11\]](#).

The inclusion of the 7% solution by a substantial minority of states has led some commentators to express concern that the uniformity of the act, as adopted across the nation, will be compromised, leading to differing administration of institutional funds based on the geographic location of each institution.

Optional Spending Safeguard for Institutions with Limited Investment and Spending Experience. In addition to the 7% solution, the UPMIFA drafting committee sets forth an optional provision as a possibility for institutions having only a small endowment. The suggested aggregate endowment level is \$2,000,000 or less, although any jurisdiction opting to use this statutory safeguard may select its own threshold level. The alternative is not included in the model statute but is, instead, set forth in the drafting committee's comments. The concept is that an institution having aggregate endowment funds of a relatively low amount would be required to give advance notice to the attorney general before spending below the aggregate historic dollar value of all endowment funds. The state attorney general would then have a period of time to review the proposed expenditures before they could actually be made. To date, no jurisdiction except New Hampshire has adopted this "small endowment" alternative.

III. Spending Concerns Expressed by the United States Senate Committee on Finance

While the UPMIFA drafting committee has provided optional statutory safeguards against overspending, the U.S. Senate Finance Committee has expressed the opposite concern, questioning whether endowments have been too frugal in providing scholarship assistance to low and middle income families. A Finance Committee release dated January 24, 2008 quotes Senator Charles Grassley's comments:

Tuition has gone up, college presidents' salaries have gone up, and endowments continue to go up and up. We need to start seeing tuition relief for families go up just as fast. It's fair to ask whether a college kid should have to wash dishes in the dining hall to pay his tuition when his college has a billion dollars in the bank. We're giving well-funded colleges a chance to describe what they're doing to help students. More information will help Congress make informed decisions about a potential pay-out requirement and allow universities to show what they can accomplish on their own initiative [\[12\]](#).

The same Senate Finance Committee release praises Harvard, Yale and Dartmouth for increasing student aid in the past year. The Committee release observes that federal law imposes a 5% distribution requirement upon most private foundations while no similar requirement exists for public charities.

The Senate Finance Committee cites a recent study of the National Association of College and University Business Officers (NACUBO) showing double-digit endowment growth at hundreds of colleges over the past year [\[13\]](#). Consequently, the Senate Finance Committee collected information from 136 US colleges with endowments of \$500 million or more on a series of questions about endowment growth and spending for student aid, and further hearings on the issue are scheduled [\[14\]](#).

While UPMIFA, even with the inclusion of the optional rebuttable presumption of imprudence for spending above 7%, does not establish a targeted spending rate, the clear implication of the US Senate Finance Committee pronouncements is that endowment expenditures of at least 5% are expected for colleges and universities, as is generally the case for private foundations.

IV. Release or Modification of Restrictions on Management, Investment or Purpose

Section 6 of UPMIFA confirms that, with the donor's consent, an institution may release or modify a gift instrument restriction upon the management, investment or purpose of an institutional fund.

PRACTICE TIP: As a practical suggestion, a university may wish to anticipate the possible future need for a release or modification and to obtain the donor's concurrence for necessary changes in advance, at the time the

gift is made. This may be particularly helpful for endowment gifts, which will continue in perpetuity. Building on a university bylaw that has been in existence since 1929, the University of Michigan maintains a practice of including the following or similar language in every gift instrument:

This Gift Agreement shall be administered in accordance with then existing Bylaws of the Regents of the University. Bylaw 3.05 indicates that the wishes of donors shall be loyally observed, so long as in the opinion of the Regents such wishes do not conflict with the proper administration of the University under changes that may develop in the course of time. Should such changes occur, the Regents shall use the Fund in a manner that satisfies the intentions of the Donor as closely as possible.

Nonetheless, if a significant modification is needed when the donor is no longer alive or available to consent, the conservative approach is to rely on UMIFA or UPMIFA, obtaining the state attorney general's input and consent and initiating a judicial action as described in the following paragraph. With the attorney general's consent, the judicial proceeding should be a streamlined process resulting in a consent decree.

In theory, an action under UMIFA is limited only to a release, not a modification or rewrite, of a donor restriction. In practice, it may be possible to modify the restriction through a court action based upon UMIFA [\[15\]](#). UPMIFA, however, clarifies the available judicial relief, permitting not only a judicial release but also expressly permitting a modification of a restriction upon a fund's management, investment or purpose.

UPMIFA incorporates the equitable doctrine of *cy pres* as well as the doctrine of equitable deviation, permitting the court, on application by an institution, to modify fund restrictions. While these equitable doctrines overlap somewhat, traditionally *cy pres* is applied to a change in the purpose or use of a charitable gift held in trust while equitable deviation deals with administrative changes in investment or management. In applying either equitable deviation or *cy pres* pursuant to UPMIFA, notice to the attorney general is required, and the attorney general must be given an opportunity to be heard before court relief is granted. UPMIFA permits the application of the doctrine of equitable deviation in the management or investment of an institutional fund, if a restriction becomes impractical, wasteful or impairs the management or investment of the fund. UPMIFA authorizes the application of the doctrine of *cy pres* to an institutional fund, permitting a modification of a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund, if the purpose or use becomes unlawful, impractical, impossible or wasteful. (In contrast, the common law doctrine of *cy pres* in general applies only if a purpose becomes unlawful, impractical or impossible).

UPMIFA also permits release or modification of smaller, older institutional funds without court action but after notice to the state attorney general. The thresholds suggested by

UPMIFA are that the fund shall have a value of less than \$25,000 and shall have been in existence for more than 20 years. Each state enacting UPMIFA, however, may determine a different amount or period of time [\[16\]](#).

Notice to donors is not required under the UPMIFA *cy pres* and equitable deviation rules or under the UPMIFA procedures for release or modification of restrictions tied to older, smaller funds.

PRACTICE TIP: It is good practice, however, to notify donors of a modification to the purpose, use or administration of a gift fund whenever possible.

V. Managing and Investing Institutional Funds

UPMIFA carries forward the concept of business judgment in the management of the investments of an institutional fund, deriving its standard from the Revised Model Nonprofit Corporation Act [\[17\]](#). UPMIFA requires that "...each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." This standard, set forth in Subsection 3(b) of UPMIFA, is mandatory and not subject to variation based on donor direction.

The standard of Subsection 3(b) is illuminated by guidelines, which are subject to donor direction, derived largely from the Uniform Prudent Investor Act [\[18\]](#) and set forth in UPMIFA's Subsection 3(e)(1) as follows:

In managing and investing an institutional fund, the following factors, if relevant, must be considered:

- (A) general economic conditions;
- (B) the possible effect of inflation or deflation;
- (C) the expected tax consequences, if any, of investment decisions or strategies;
- (D) the role that each investment or course of action plays within the overall investment portfolio of the fund;
- (E) the expected total return from income and the appreciation of investments;
- (F) other resources of the institution;
- (G) the needs of the institution and the fund to make distributions and to preserve capital; and
- (H) an asset's special relationship or special value, if any, to the charitable purposes of the institution.

Uniform Prudent Investor Act standards apply by their terms only to private and charitable trustees and not to nonprofit corporations. By incorporating the Uniform Prudent Investor

Act standards, UPMIFA causes the investment rules to become uniform for all charities, regardless of the entity status of the charitable organization.

Also borrowing from the Uniform Prudent Investor Act [19], UPMIFA Subsection 3(e)(2) requires investment decisions to be made in the context of the portfolio of investments as a whole, not in isolation in respect to individual assets. While program-related assets (assets held primarily to accomplish charitable purposes rather than to yield an investment return) are not subject to UPMIFA, Subsection 3(e)(1)(H) suggests that the special relationship of an investment asset to the charitable purposes of the institution should be considered in managing and investing an institutional fund. This would be the case, for example, for a research university's technology transfer fund established to serve the purpose of transferring university-generated intellectual property to commercial use, with the fund's holding royalty and start-up equity interests for investment purposes. Another example is the University of Michigan Wolverine Venture Fund, which was established primarily for educational purposes in the university's business school, with the fund holding venture capital assets screened by business school students.

PRACTICE TIP: Identify program-related assets at your institution. If program-related assets serve, in part, as investments of your institution, however, separate reporting categories or investment criteria may be appropriate, as is discussed in more detail in Appendix II.

VI. Incurring Only Costs that Are Appropriate and Reasonable

UPMIFA Section 3(c)(1) mandates that an institution "...may 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..." The issue of managing costs is not addressed in UMIFA.

The new statutory provision raises the question of exactly what costs may be allocated to a university's endowment or other institutional fund. Some universities, for example, allocate a portion of their fundraising expenses to their pooled endowment fund. Such costs may be justifiable, if reasonable in amount, because fundraising activities contribute significantly to the growth of the university's overall endowment. Each dollar invested in fundraising activities may yield many multiples of that amount for the endowment. Thus, a reasonable allocation for a portion of fundraising activities seems a prudent investment in much the same way as investing in a diversified, well chosen portfolio of investment securities is prudent. Further, since private, and to an increasing extent public, universities must be self sustaining, fundraising goals are increasingly focused on endowment and capital purposes, to permit the institution to build, grow and be self sufficient. These costs then, in the words of UPMIFA, seem to be "reasonable in relation to ...the purposes of the institution..." [20]. Interestingly, the UPMIFA drafting committee considers the possibility of charging fundraising expenses as a fund expense, not in the context of managing costs so that they are appropriate and reasonable as set forth in Section 3, but rather in the context of the 7% solution under UPMIFA Section 4. The 7% solution, discussed earlier, is an optional statutory safeguard that would raise the rebuttable presumption that spending

from an endowment is imprudent if spending exceeds 7% of the fund's value. In this context, drafting committee comments indicate that fundraising and administrative expenses other than investment management expenses should be considered part of the fund appropriated for expenditure, not as a cost of managing the endowment itself. The official comment reads as follows:

Expenditures from an endowment fund may include distributions for charitable purposes and amounts used for the management and administration of the fund, including annual charges for fundraising. The value of a fund, as calculated for purposes of determining the seven percent amount, will reflect increases due to contributions and investment gains and decreases due to distributions and investment losses. The seven percent figure includes charges for fundraising and administrative expenses other than investment management expenses. All costs or fees associated with an endowment fund are factors that prudent decision makers consider. High costs or fees of investment management could be considered imprudent regardless of whether spending exceeds seven percent of the fund's value.

PRACTICE TIP: If your institution charges fundraising or administrative expenses (other than investment management expenses) to endowment funds, such expenses might be considered as part of the endowment distribution itself rather than a fund expense. The total endowment distribution, inclusive of such expenses, should be justifiable under the standards of UMIFA section 4.

VII. Delegation of Management and Investment Functions

Without providing standards or guidelines, UMIFA permits a governing board to delegate investment authority and to contract and pay for an investment advisor's services [21]. UPMIFA permits delegation to an external agent, incorporating the delegation rule found in the Uniform Prudent Investor Act [22]. Based on a standard of "...good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, ..." Section 5 of UPMIFA permits delegation under this standard in selecting an agent, establishing the scope and terms of delegation and periodically reviewing the agent's actions to monitor performance and compliance under the terms of the delegation. In turn, the selected agent owes a duty to the institution to exercise reasonable care, and, moreover, submits to court jurisdiction by virtue of accepting the delegated authority. An institution properly delegating to an external agent is not liable for decisions or actions of the agent to which the function was delegated.

PRACTICE TIP: Document that your institution meets the UPMIFA standards relating to selecting an agent, establishing the scope and terms of delegation and periodic review, in order to utilize UPMIFA's protection against institutional liability for the decisions and actions of the agent.

The Drafting Committee's preliminary comments to Section 5 indicate that UPMIFA

investment standards depend on the power to delegate and that, for more complex investments, prudent investing requires delegation.

Delegation of decision-making authority regarding expenditures is not authorized by UPMIFA, as spending decisions should be made by the institution itself. Also, UPMIFA does not address the issue of internal delegation to committees, officers or employees, on the premise that such matters are covered by other state law [\[23\]](#).

CONCLUSION:

UPMIFA has modernized UMIFA's investment conduct standards, incorporating guidelines introduced by the Uniform Prudent Investor Act. As a result, investment rules become uniform for all charitable institutions regardless of their entity status. UPMIFA's rules for the release or modification of fund restrictions are broadened and more useful while delegation rules found in UPMIFA are more complete and permit an institution to avoid liability for the agent's misconduct if proper steps have been taken in establishing and monitoring the delegation.

As of this writing 24 states and the District of Colombia have adopted UPMIFA, and legislation to adopt UPMIFA has been introduced in an additional 8 states. Of interest will be trends in selecting or rejecting UPMIFA's optional 7% solution, which affects an institution's endowment expenditures, as further jurisdictions consider UPMIFA. If jurisdictions remain split on the 7% solution, one element of the new act's uniformity will be compromised. Regardless of the outcome, discarding the historic dollar value endowment spending limitation, relying instead on the requirement of prudence, is a significant advance and will enhance the ability of each college or university to administer a uniform endowment spending policy that is applicable to all of its endowment accounts.

[FOOTNOTES](#)

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RESOURCES:

Appendix I:

[Text of UPMIFA as promulgated by NCCUSL](#)

Appendix II:

[Discussion of NCCUSL Definitions](#)

Model Statutes:

- [Uniform Prudent Management of Institutional Funds Act](#)
- [Uniform Management of Institutional Funds Act](#)
- [Uniform Prudent Investor Act](#)
- [Revised Model Non-Profit Corporations Act](#)
- [National Conference of Commissioners on Uniform State Laws \(NCCUSL\)](#)

NACUA Outlines:

- [Strings on Dollars: From UMIFA to UPMIFA: The New Uniform Prudent Management of Institutional Funds Act](#) / Quinn R. Frazer, June 2007.
- [Strings on Dollars: Dealing with Gift Restrictions and "What to Do When a Gift's Purpose is Frustrated by a Change in Circumstances](#), Lorraine Sciarra. June 2007.
- [Problem Gifts and Prudent Investments](#), Quinn Frazer. June 2006.

Journal of College and University Law:

- [Taxing and Regulating College and University Endowment Income: The Literature's Perspective](#), Mark J. Cowan. 34 JCUL 507 (2008).

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