Client Advisory

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Trusts and Estates

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Important Changes to New York Not-For-Profit Corporation Law

On September 17, 2010, New York adopted the New York Prudent Management of Institutional Funds Act (the "Act"),[1] dramatically changing and updating New York law concerning the management and investment of institutional funds[2] and spending of endowment funds.[3] The Act applies to all organizations defined as "institutions"[4] under the Act, such as public charitable organizations, private foundations and practically every corporation formed under the New York Not-For-Profit Corporation Law ("N-PCL"), including non-charitable membership organizations such as athletic, social, professional and civic organizations formed as corporations under the N-PCL. The Act is effective immediately and applies to institutional funds existing on or established after the effective date of the Act, and to decisions made or actions taken subsequent to enactment, subject to the exceptions noted below. In particular, the Act will require institutions to review investment, management and endowment spending policies. Specifically, the Act provides:

- stronger guidance to institutions regarding investment management and a clearer and more specific set of rules for investing in a prudent manner;
- a requirement that all institutions adopt an investment policy;
- an updated standard of conduct for delegating investment and management authority in a prudent manner;
- flexibility to institutions by no longer necessarily restricting endowment spending to amounts above historic dollar value; and
- expanded and new ways for institutions to seek a release or modification of a donor-imposed restriction on an institutional fund.

For more information, please see the detailed summary below outlining in greater detail the major changes enacted by the Act. It is important to note that the Act provides default rules and the Act's provisions are subject to the intent of the donor expressed in a gift instrument.[5] Therefore, donors may restrict an institution's discretion to spend, manage and invest a fund with express language in a gift instrument. *In light of the Act, donors will need to consider restrictions on endowment gifts before making them, and institutions will need to consider any such specific restrictions prior to accepting such gifts.*

Standard of Conduct in Managing and Investing an Institutional Fund

The Act requires that institutions adopt a written investment policy setting forth guidelines on investments and delegation of management and investment functions in accordance with the standards of the Act. *Accordingly, we recommend that all institutions should prepare promptly a written investment policy to be adopted by their governing boards.*

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Although the Act articulates a prudence standard for investment management similar to the prior law, which standard is good faith and with the care an ordinarily prudent person would exercise under similar circumstances unless a person has special skills or expertise,[6] the Act provides stronger guidance to institutions for investment management and lists a clearer and more specific set of rules for investing in a prudent manner. When investing, the Act requires institutions to consider factors such as the effects of inflation or deflation, general economic conditions, total return, tax consequences of investment decisions or strategies and the role that each investment or course of action plays within the overall investment portfolio of the fund. Institutions may only incur investment costs that are "appropriate and reasonable." The Act imposes a duty to diversify investments unless the institution prudently determines the purposes of the fund are better served without diversification. There is also a duty to review at least annually a decision not to diversify. Furthermore, within a reasonable time after receiving a gift, an institution must make and carry out decisions concerning the retention or disposition of the property. Additionally, institutions should be aware that compliance with the Act is determined in light of the facts and circumstances existing at the time a decision is made or action is taken, and not retrospectively. *Although not required by the Act, we recommend that an institution keep a contemporaneous recording of how the institution considered each factor when making investment decisions.*

Standards for Delegation of Investment and Management Functions to Outside Professionals

Under the Act, as under the prior law, institutions may delegate to outside managers or investment advisors the management and investment of an institutional fund unless restricted by the gift instrument. The Act now specifically provides that the institution must act prudently in selecting, continuing or terminating the agent, establishing the scope and terms of the delegation and monitoring the agent's performance. An institution that complies with the above standard is not liable for the actions of the agent. *Institutions should verify that their written investment policies reflect these standards.*

Endowment Spending

One of the Act's most important changes pertains to spending from endowment funds. Under the prior law, institutions were subject to the "historic dollar value" ("HDV") limitation, meaning that the institution generally could spend the income earned on the endowment fund and the amount of appreciation over the HDV which the institution deemed prudent, but could not spend at or below the HDV.

In our current economic downturn, the Act provides much-needed flexibility to institutions by no longer restricting spending to amounts above HDV. Under the Act, an institution may spend the amount the institution deems prudent, and may even dip below the original dollar value, after considering eight factors, including the donor's intent that the endowment fund continue permanently, the purposes of the fund, relevant economic factors, total return, other resources and the investment policy of the institution, and, where appropriate, alternatives to expenditure. *The institution is required to keep a contemporaneous record describing the consideration that was given by the governing board to each of the factors enumerated in the Act.* For any fund, whether or not existing before the effective date of the Act, the gift instrument controls and will override an institution's ability to invade HDV if prohibited by the gift instrument.

In order to limit excessive spending, the Act creates a rebuttable presumption of imprudence for spending above 7% of the fair market value of an endowment fund. However, spending 7% or less does not create a presumption of prudence. The 7% rebuttable presumption applies only to funds created on or after the effective date of the Act. For funds existing prior to September 17, 2010, the institutions will not have the 7% safe harbor and will be held solely to a prudence standard.

As noted above, in the gift instrument, donors can set forth a specific spending level, rate or amount. Donors should be aware of this option when making gifts. *The Act also requires that institutional solicitations for an endowment fund include a statement that, unless otherwise restricted by the gift instrument, the institution may expend so much of an endowment fund as it deems prudent after considering the factors set forth in the Act.*

With respect to gifts made prior to the Act's effective date of September 17, 2010, the Act requires 90 days advance notice to the donor if alive and identifiable with reasonable efforts before appropriating from the applicable endowment fund for the first time. This requirement gives the donor the ability to prohibit the institution from spending below the original dollar value of the fund by responding to the notice. Notice is not required if (a) the gift instrument permits appropriation for expenditure without regard for the fund's HDV; (b) the gift instrument limits the institution's authority to appropriate for expenditure with explicit limiting language, such as specifying a spending level, rate or amount; or (c) the gift consists of funds received as a result of institutional solicitation without a separate statement from the donor expressing a restriction on the use of funds. The notice requirement is complicated and detailed. *Therefore, institutions should seek advice before appropriating from an endowment fund for the first time after the effective date of the Act.*

Release or Modification of Restrictions

Under the prior law, an institution could seek release of donor-imposed restrictions placed on gifts by obtaining the written approval of the donor. If the restriction was obsolete, inappropriate or impracticable and the donor was unavailable due to death, disability or impossibility of identification, the institution could statutorily seek court release with prior notice to the Attorney General. A charity could also seek court modification of a donor-imposed restriction on an endowment fund by way of a *cy pres* proceeding, provided that the donor consented (if living).

The Act expands the situations under which an institution may seek a release or modification of a restriction on an institutional fund by allowing an institution to seek relief in court even if the donor is available. The institution must provide notice to an available donor and the Attorney General. Additionally, for funds of less than $100,000 which are over 20 years old, the Act permits institutions to release or modify restrictions unilaterally (without court involvement), with prior notice to the donor (if available) and the Attorney General.

Conclusion

The following steps should be taken by all institutions governed by the Act:

1. Educate your governing boards about the requirements of, and changes resulting from, this Act.
2. Promptly adopt a written investment policy incorporating the standards of the Act.
3. Set up procedures to notify existing donors prior to appropriating below original dollar value for the first time.
4. Revise solicitation materials for endowment funds.

Donors should also be aware of their ability to restrict spending from endowment funds in the gift instrument in light of the changes described above. We also recommend that a donor's gift instrument name a representative to act on behalf of the donor if the donor is unavailable to interact with an institution regarding management and maintenance of the gifted fund.

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1 The Act is New York's form of the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). UPMIFA, which has been enacted in 47 states and the District of Columbia, was created to revise the outdated provisions of the Uniform Management of Institutional Funds Act.

2 An "institutional fund" is defined as a fund held by an institution, but does not include program-related assets, funds held for an institution by a trustee that is not an institution or a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purpose of the fund.

3 An "endowment fund" is defined as an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis.

4 An "institution" is (1) a person, other than an individual, organized and operated exclusively for charitable purposes; (2) a trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated; or (3) any corporation described in subparagraph five of paragraph (a) of section 102 of the N-PCL.

5 A "gift instrument" is defined as a record or records, including an institutional solicitation, under which property is granted to, transferred to, or held by an institution as an institutional fund.

6 Under the Act, a person that has special skills or expertise, or is selected in reliance upon the person's representation that the person has special skills or expertise, has a duty to use those skills or that expertise in managing and investing institutional funds.