Uniform Prudent Management of Institutional Funds Act Liberalizes Endowment Spending and Clarifies Investment Standards for Charitable Institutions

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Massachusetts recently joined 39 other states and the District of Columbia by enacting a version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA). Most notably, and in contrast to prior law, UPMIFA permits Massachusetts institutions that hold funds exclusively for charitable purposes to tap into endowment funds whose values have depreciated below their "historic dollar values" (i.e., "underwater" endowment funds). The new law, which is effective as of June 30, 2009, also applies to funds held by a trustee for a charitable community trust.

Due to the recession, many Massachusetts charities have underwater endowment funds. Under prior law, expenditure of an endowed fund below its historic dollar value was prohibited unless explicitly permitted by the terms of the gift instrument. This restriction left many institutions without the ability to access the principal of such underwater funds in times of economic need. In contrast, under UPMIFA, the principal of an endowment fund – even an underwater endowment fund – may be spent if it is prudent to do so (as discussed below).

UPMIFA defines "endowment fund" as an institutional fund (or a part thereof) that, under the terms of the gift instrument, is not wholly expendable by the institution on a current basis. This term does not include assets that an institution designates as an endowment fund for its own use.

UPMIFA provides default rules that in most circumstances defer to clearly expressed donor intent. However, UPMIFA specifies that terms in a gift instrument designating a gift as an endowment, or an authorization in the gift instrument to use only "income", "interest", "dividends", or "rents, issues, or profits", or "to preserve the principal intact", or words of similar import do not, standing alone, limit the authority of the institution to spend the principal of an endowment fund. Thus, under UPMIFA, these terms are not considered explicit donor instructions that on their own prohibit the expenditure of endowment fund principal.

Rebuttable presumption eliminated

Under prior Massachusetts law, a rebuttable presumption of imprudence attached to expenditures of appreciation greater than seven percent of an endowment fund's average value, calculated on a rolling three-year basis. This has been eliminated under the version of UPMIFA adopted in Massachusetts.

Use of endowment funds

UPMIFA requires that general standards of prudence and good faith apply to any decision to spend endowment funds. In addition, UPMIFA requires that the following factors, if relevant, be considered as part of any decision to spend endowment funds:

- Duration and preservation of the endowment fund
- The purposes of the institution and the 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
- The investment policy of the institution

After considering these factors and confirming that the gift instrument for the relevant fund does not contain instructions to the contrary, an institution may determine to spend the principal of an underwater endowment fund. Careful documentation of all such decisions is advisable, including the consideration of all of the relevant factors discussed above.

Institutions with endowment funds are also advised to update their endowment management and spending policies to reflect the relevant criteria included in UPMIFA.

Modification of donor restrictions on investment funds

UPMIFA updates, clarifies, and somewhat liberalizes standards governing the modification of donor restrictions on investment funds:

Donor consent. As under prior law, a charitable institution may modify the terms of an endowed gift with the donor's written consent.

Equitable deviation. Importing modern equitable deviation standards from trust law, UPMIFA adds wastefulness as grounds for deviation and removes a requirement under prior law that donor consent be impossible to obtain. Thus, under UPMIFA, a charitable institution may petition a court to modify a restriction on the management, investment, or duration of a fund if the restriction is impracticable or wasteful, impairs the management or investment of the fund, or if modification would further the purposes of the fund because of circumstances unforeseen by the donor. The modifications must be, to the extent practicable, consistent with the donor's intent. UPMIFA also eliminates a prior prohibition on the conversion of an endowment fund to a non-endowment fund.

Cy pres. UPMIFA codifies and imports from trust law specific standards for the application of cy pres. Cy pres involves judicial modification of the purposes or restrictions on the use of an endowment gift if it becomes unlawful, impracticable, impossible to achieve, or wasteful.

Administrative approval. Under UPMIFA, the Supreme Judicial Court (SJC) may authorize the Massachusetts Attorney General to approve modification requests for certain funds, including funds smaller than a given size. If the SJC follows the language of the Uniform Law Commission's model act, funds of more than 20 years of age and with less than $25,000 in assets may not require judicial approval for modification.

Standards for investment

UPMIFA incorporates modern portfolio theory and applies the prudence standard of trust law to all charitable organizations. In addition to imposing overarching fiduciary duties of loyalty and care, UPMIFA specifies certain additional obligations:

Investment decisions. Investment decisions must be made in the context of the entire portfolio. These decisions must reflect consideration of the following factors:

- General economic conditions
- Possible effect of inflation or deflation
- Expected tax consequences of investment decisions or strategies
- Role of each investment or strategy in the overall portfolio
- Expected total return of the investments
- Other resources of the institution
- Needs of the institution
- An asset's special relationship to charitable purposes of the institution

UPMIFA also specifies that the persons managing and investing institutional funds have a duty to use any special skills or expertise that they possess.

Diversification. Institutions have a duty to diversify investments except in special circumstances and must make decisions concerning the retention or disposition of new property within a reasonable time after receiving such property.

Delegation. An institution may delegate the management of an institutional fund to an agent, but must exercise prudence and good faith in selecting, instructing, and monitoring the agent. Agents performing duties for nonprofit institutions in this manner automatically become subject to personal jurisdiction in Massachusetts.

Costs. Institutions have a duty to minimize costs and a duty to allocate costs reasonably to each fund prior to any appropriations.

Effective date

UPMIFA applies to endowment funds existing on or established after June 30, 2009. As applied to endowment funds existing on June 30, 2009, UPMIFA governs only decisions made or actions taken on or after that date.

Accounting requirements

Financial Accounting Standards Board Staff Position 117-1 (FSP FAS 117-1), issued last August, requires charitable institutions operating under UPMIFA to classify their endowment funds into permanently and temporarily restricted assets and provide the legal rationale underlying the classifications. FSP FAS 117-1 also mandates that all institutions provide enhanced disclosure regarding endowment spending and investment policies, asset composition, and performance.

This memorandum is not intended to provide legal or tax advice. For more information or advice regarding the new filing requirement, please contact Shirin Philipp or Sharon Lincoln of Foley Hoag's Nonprofit Practice Group or contact your lawyer at Foley Hoag.

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