

UPMIFA, Three Years Later

What's a Prudent Director to Do?

By Cynthia R. Rowland

When the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Prudent Management of Institutional Funds Act (UPMIFA) in July 2006, they could not have predicted how imprudent the financial world would seem to nonprofit board members three years later. From the 2008 stock market crash and the collapse of mortgage-backed securities, to the discovery of Bernard Madoff's Ponzi scheme, prudent managers of institutional funds held by nonprofit corporations and charitable trusts now contend with an investment environment that has been warped by optimistic illusions, fraud, and greed. The continued congressional scrutiny of nonprofits, spearheaded by Senator Grassley, as well as the Obama administration's commitment to public institution transparency, also color the current financial culture in which nonprofit directors find themselves. Adding it all up, prudent nonprofit directors are in a fine pickle these days: shrinking investment assets, increased demand for charitable services and grants, increased scrutiny, and an untested new law.

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The NCCUSL drafting committee worked hard to improve the Uniform Management of Institutional Funds Act (UMIFA) by modernizing endowment fund rules for fiduciaries. Indeed, UPMIFA does take into account important facts and circumstances for investment policies, spending policies, expense management, and delegation in ways that UMIFA did not. The business lawyer serving on a board in 2009 should be knowledgeable about the changes in the law at this particularly perilous time for investment management. The rules of the new UPMIFA regarding investment policies do not differ fundamentally from the rules under UMIFA, which was adopted in 35 states and the District of Columbia beginning in 1972. The spending policy rules are very different, though. The bright-line historic dollar-value floor on spending from an endowment fund that applied under UMIFA has been replaced with rules that allow invasion of principal and require the directors to be "prudent" under the facts and circumstances. In addition, many states have adopted a "presumption of imprudence" for spending rates in excess of 7 percent per year. The potential consequences of getting it wrong have many volunteer board members looking nervously for an exit. This article focuses on the new prudent spending rules being adopted as the states replace UMIFA with UPMIFA, in light of the prudent investment rules and today's economic reality for

institutions. After summarizing the relevant aspects of UPMIFA, I offer some observations about how board members can approach the difficult spending decisions that face them today.

Not surprisingly, the uniformity goal of UPMIFA has been a bit thwarted by the states; there are several variations on the theme. Table I shows the states that have adopted UPMIFA, the effective date, and whether the optional presumption of imprudence has been adopted. There are several other interesting aspects of UPMIFA that are not discussed at length in this article, including the new rules on investment expenses and the self-modification procedures for small, old funds. Helpful details about those aspects, as well as a nice history of UMIFA and UPMIFA, can be found at the Uniform Law Commission's website on UPMIFA (www.upmifa.org).

Background

In addition to corporate law articulating standards of conduct generally, those states that have adopted UPMIFA apply specific rules to the directors' duties governing the investment and expenditure of a nonprofit corporation's investment assets. The spending rules apply only to invested assets held by a charitable institution subject to the donor's instruction that the assets may not be wholly expended in one year. Thus, these rules do not apply to so-called quasi endowments or board-designated endowments, which are

rainy-day funds set aside by a board, but not subject to donor restrictions. The UPMIFA spending rules do apply to assets that are intended to be held either for a stated term of years or for perpetual duration.

Investment Policies

UPMIFA requires that in managing and investing an institutional fund, subject to the intent of a donor expressed in a gift instrument, the board must consider

- The charitable purposes of the institution and the purposes of the institutional fund.
- 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.
- An asset's special relation or special value, if any, to the charitable purposes of the institution.

In addition, managers of institutional funds must not make fund management and investment decisions in isolation. With each decision, they are to consider the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy. The strategy must be based on risk and return objectives suited to the fund and to the institution. The board must diversify the investments unless the board members determine that, because of special circumstances, the purposes of the fund are better served without diversification. Subject to these standards, the directors can invest the endowment in any kind of property or type of investment.

The board may delegate to an external agent the management and

investment of the endowment fund, but must act prudently and in good faith in selecting the agent and establishing the scope and terms of the delegation. The board must periodically review the agent's actions. In the last 20 years, most nonprofits have come to rely substantially upon the recommendations of professional money

The board may delegate investment of the fund, but must act prudently and in good faith.

managers, and the relevant statutes authorize the board to rely upon professional investment counsel's advice. There are still some nonprofits whose board members feel comfortable working without professional investment advisors, although those are few and far between.

Spending Policies

UPMIFA also sets forth rules governing spending policies for endowment funds. Under UMIFA, the rules were fairly straightforward: as long as the institution did not invade the "historic dollar value," any spending rate would be fine. UMIFA's premise was that the sum of all contributions to a fund, which contributions were restricted by the donor to be held as an endowment, would peg the amount that could never be spent: the historic dollar-value floor. UMIFA did not include an inflation factor and did not specifically require the board to consider whether the purchasing power of the original gift would be preserved when making decisions about the spending rate. So long as the original contribution was never invaded, any amount of spending was permitted.

In some ways, UPMIFA provides considerably more flexibility. Within the boundaries of the donor's intent as expressed in the gift instrument, an institution may spend or accumulate so much as the board determines is

prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. Of course, if the gift instrument states a particular spending rate or formula, that rate or formula will apply and the board has no discretion in determining the spending policy with respect to that particular fund, and UPMIFA does not alter the donor's instructions. Otherwise, in making a determination to appropriate or accumulate assets in an endowment fund, the board members, acting in good faith, are to apply the prudent person standard, and consider, if relevant

- 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.
- The investment policy of the institution.

UPMIFA's Big Idea on Spending

The big idea behind UPMIFA's revision of the spending policy rules was to promote a total return approach to spending, akin to the total return approach to investments. Or, stated another way, spending policy decisions are the flip side of investment policy decisions: invest at a rate that over the long term will preserve the purchasing power of the principal and spend at a rate that over the long term will effect the donor's intent to serve the charitable purpose each year. In the comments to section 4, the Drafting Committee noted that

[i]nstitutions have operated effectively under UMIFA and have operated more conservatively than the historic dollar value rule would have permitted. Institutions have little incentive to maximize allowable spending. Good practice has been to provide for modest expenditures while maintaining the purchasing power of a fund. Institutions have

followed this practice even though UMIFA (1) does not require an institution to maintain a fund's purchasing power and (2) does allow an institution to spend any amounts in a fund above historic dollar value, subject to the prudence standard. The Drafting Committee concluded that eliminating historic dollar value and providing institutions with more discretion would not lead to depletion of endowment funds. Instead, UPMIFA should encourage institutions to establish a spending policy that will be responsive to short-term fluctuations in the value of the fund. Section 4 allows an institution to maintain appropriate levels of expenditures in times of economic downturn or economic strength. In some years, accumulation rather than spending will be prudent, *and in other years an institution may appropriately make expenditures even if a fund has not generated investment return that year.* [Emphasis added.]

Unfortunately, the Drafting Committee did not articulate what should happen in the case of a catastrophic decline in value, as we have seen in the last year. Of course, the financial services industry has developed abundant quantitative models that will illustrate for a board the spending rate that would preserve the purchasing power using performance models developed over the last several decades. However, they will always footnote the idea that past performance does not indicate the results that will be obtained in the future. On the flip side, there are no models for institutional directors to rely on in determining the spending rate that will preserve the donor's intent to serve the particular charitable program envisioned at the time of the gift. While it is relatively easy to assist a board in determining defensible investment and spending policies based on the recommendations of investment professionals who will readily advise on risk-adjusted asset allocations, the spending policy factors of UPMIFA require the board to focus

TABLE I: UPMIFA Adoption and Special Rules

STATE	EFFECTIVE DATE	PRESUMPTION	COMMENTS
Alabama	Jan. 1, 2009	No	
Arizona	Apr. 14, 2008	No	
Arkansas	Feb. 26, 2009	No	
California	Jan. 1, 2009	Yes	In California, the presumption of imprudence does not apply to a private or public post-secondary educational institution or to a campus foundation established by and operated under the auspices of such an educational institution. Cal. Prob. Code § 18504(d)(2).
Colorado	Sept. 1, 2008	No	
Connecticut	Oct. 1, 2007	No	
Delaware	July 31, 2007	No	
District of Columbia	Jan. 23, 2008	No	
Georgia	July 1, 2008	No	
Hawaii	July 1, 2009	No	
Idaho	July 1, 2007	No	
Illinois			Pending—Passed both houses May 22, 2009.
Indiana	July 1, 2007	No	
Iowa	July 1, 2008	No	
Kansas	Jan. 1, 2009	No	
Maryland	June 1, 2009	Yes	
Michigan			Pending—SB 0411 (2009)
Minnesota	Apr. 10, 2008	No	
Mississippi			Died on adjournment
Missouri			Pending HB 239
Montana	Oct. 1, 2007	Yes	
Nebraska	Sept. 1, 2007	No	
Nevada	Oct. 1, 2007	Yes	
New Hampshire	July 1, 2008	Yes	
New Jersey			Pending—A3871/S2853
New Mexico	July 1, 2009	No	
North Carolina	Mar. 19, 2009	No	
North Dakota	Apr. 21, 2009	Yes	
Ohio	Apr. 7, 2009	No	Appropriation of not more than 5 percent creates an irrebuttable presumption of prudence.
Oklahoma	Nov. 1, 2007	No	
Oregon	Jan. 1, 2008	Yes	
South Carolina	July 1, 2008	No	
South Dakota	July 1, 2007	No	
Tennessee	July 1, 2007	Yes	
Texas	Sept. 1, 2007	Yes	Texas applies the 7 percent presumption only to an endowment fund with an aggregate value of \$1 million or more. For endowment funds of less than \$1 million, a spending rate of greater than 5 percent is presumed to be imprudent. A special rule applies to university systems. See Tex. Prop. Code Ann. 163.005 (Vernon).
Utah	Apr. 30, 2007	Yes	
Vermont	May 5, 2009	No	
Virginia	July 1, 2008	No	
Washington	May 11, 2009	No	
West Virginia	July 1, 2009	Yes	Rebuttable presumption of imprudence if expenditures exceed 5 percent, but no presumption of prudence if expenditures are less than 5 percent.

also on qualitative decisions about the donor's and the institution's evaluation of intergenerational fairness, programmatic disruptions caused by dramatic changes in funding, inefficiencies created by stop-and-go funding approaches, and the fact that the needs may be greatest during the phase of the economic cycle that most dramatically reduces the investment earnings from the fund.

There is little guidance in UPMIFA or the comments about how a prudent board resolves this dilemma, but it is clear that if they get it wrong, the state's attorney general can enforce the charitable interests of the public.

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The problem for directors is particularly acute in the states that adopted the "presumption of imprudence." At the time this article went to press, nine states had adopted the presumption that a particular spending rate, stated as a percentage, is imprudent (see Table I). This rebuttable presumption in section 4(d) of UPMIFA provides that the "appropriation for expenditure in any year of an amount greater than 7 percent of the fair market value of an endowment fund, calculated on the basis of market value determined at least quarterly and averaged over a period of not less than three years immediately preceding the year in which the appropriation for expenditure is made, creates a rebuttable presumption of imprudence." There is not, however, a "presumption of prudence" for any appropriation less than or equal to 7 percent.

Before delving into some practical discussions of board decision-making criteria, some ambiguity in the drafting of the presumption deserves discussion. The fair market value to which

the presumption is to be applied is "calculated on the basis of market value determined at least quarterly and averaged over a period of not less than three years immediately preceding" the year of appropriation. In the comments to UPMIFA, the commissioners stated:

The period that a charity uses to calculate the presumption (three or more years) and the frequency of valuation (at least quarterly) will be binding in any determination of whether the presumptions [sic] applies. For example, if a charity values an endowment fund on a quarterly basis and averages the quarterly values over three years to determine the fair market value of the fund for purposes of calculating 7 percent of the fund. The charity's choices of three years as a smoothing period and quarterly as a valuation period cannot be challenged. If the charity makes an appropriation that is less than 7 percent of the value, then the presumption of imprudence does not arise even if the appropriation would exceed 7 percent of the value of the fund calculated based on monthly valuations averaged over five years.

Most institutions do look back just three years in determining their spending policy, but given last year's dismal performance, and in light of the comments to UPMIFA, the institutions may be better served if they amend their spending policy now and adopt a longer smoothing period with more frequent valuation dates. Using quarterly data from the last 10 years may suggest that a higher amount of appropriation is not imprudent. The statute does not articulate how often the board can revisit this decision, but clearly if the spending rate desired is at a rate that exceeds the ceiling in the presumption, the well-advised board may want to change its spending formula. On the other hand, many charities may not have an articulated formula for determining a payout rate, and so presumably the quarterly/three-year periods

would apply by default.

In any event, consider the predicament of a charity that has only one permanent endowment fund, and that fund lost 30 percent of its value since December 31, 2007. Assume that for many years it had budgeted and spent each year, under the typical pre-UPMIFA spending policy, an amount equal to 5 percent of its asset value calculated at the close of each of the three immediately preceding fiscal years. Its investment policy had been designed to match the long-term historically achievable investment performance of 5 percent after expenses, but had not accumulated any earnings, so that the fair market value was equal to its historic dollar value. Let's assume, for argument's sake, that neither the donor nor her heirs are available to advise the board about intent, that the gift instrument is specific enough to indicate that the fund was intended to be maintained in perpetuity, but that there is no specific stated instruction for this turn of events.

As Scenario A of Table II illustrates, if the institution maintains the same spending rate, there is no further market decline, and the institution is able to generate the historic 5 percent return on its remaining capital, then the institution's spending policy will be presumptively imprudent under UPMIFA by 2011, and the endowment will be depleted by about 2030.

Scenario B shows that if the institution immediately reduces its spending rate to match 5 percent of the principal after the dramatic market reduction, it can avoid falling into the presumptively imprudent range, particularly if the market returns to normal historic patterns for the same risk-adjusted asset allocation that the institution had in place before the market correction. Assuming that over the long term the board maintains the pre-2008 investment policy that generated, on average, annual returns of 5 percent, this institution will forever maintain a reduced spending rate.

If UPMIFA applies, or if the board decides not to spend any amount until the corpus recovers, then the institution would not be able to support any charitable activities until the historic dollar

value is recovered. Accordingly, applying the normal growth and investment assumptions, Scenario C shows that this will happen in 2018.

Several aspects of the three simplified scenarios in Table II merit comment. First, a board that wishes to maintain spending at the historic rate now has the option of doing so, in states that have adopted UPMIFA. If the state has adopted the rebuttable presumption of imprudence, the board will need to document why the current programmatic needs are so important (or, perhaps, are legally or contractually required) that the risk of depletion is acceptable. The board also should document a plan for restoring the principal amount, either by fund-raising, by adopting an investment policy that is more aggressive, or by implementing other revenue streams through related or unrelated business activities. Each of those approaches does, of course, entail myriad other business risks.

The board that adopts Scenario B is unlikely to face depletion; however, its charitable impact is permanently reduced. That board in principle accepts

the lower funding model in perpetuity, since, absent fund-raising, aggressive investments, or other revenue streams, the programmatic spending is unlikely to ever return to pre-2008 levels. Note, however, that private foundation boards must adopt this model because they are required to distribute at least 5 percent per year, unless there are other revenue sources for meeting the minimum distribution requirement of section 4942 of the Internal Revenue Code.

The board that adopts Scenario C gets to take the next decade off from any grant-making activity while the corpus recovers. Its responsibilities will be limited to documenting how the decision to accumulate comports with donor intent and keeping close tabs on the investment performance. This board is unlikely to face attorney general scrutiny in states that have adopted UPMIFA because there is no corollary presumption of imprudence if there are no expenditures. If this board also believes that the corpus should be increased to keep up with inflation, the accumulation period will be even longer.

Summary

UPMIFA allows directors the freedom to choose whether to spend or accumulate, to adopt an investment policy that meets the intent of the endowment fund, and to apply their business judgment to management of the charity's endowment assets without arbitrary limits. In those states that have adopted section 4(b) of UPMIFA, the presumption of imprudence challenges that freedom and may effectively induce institutions to dramatically reduce their spending rate. Few volunteer directors are keen to make decisions that are "presumed" to be imprudent. For those hearty souls with the desire to keep programs running despite dramatic losses, the best advice is to document thorough analysis of the human and programmatic costs of reducing spending, as well as any applicable laws or donor requests. At the same time, board members reconsidering the investment policies will need to maintain a growth orientation, which, given the events of the last 12 months, requires enormous fortitude and confidence.

TABLE II: Recovery and Spending Rates

