The Endowment Fund Quagmire: A Critical Look at Perpetuity

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1

Donor Restrictions

- Accounting rules vs. legal principles
- Accounting rules do **not** affect the board's rights and obligations

2

Donor Restrictions

- Accounting standards (SFAS 116 and 117) – only three types of nonprofit assets:
  - Permanently restricted
  - Temporarily restricted
  - Unrestricted

3

Donor Restrictions

- Legal principles – only two types of assets:
  - Restricted (charitable trust law)
    - Duration (endowment)
    - Purpose
  - Unrestricted

4

Donor Restrictions -- So Who Cares?

- Donor
- Donor's family
- Attorney General

5

Unrestricted Funds

- Importance of recordkeeping
  - Effect of commingling
  - Fund accounting
- "Quasi-endowment" funds
  - Board-restricted
  - "Rainy day" fund
  - Effect on future boards?

6

Perpetuity is a Long Time….

- Cy Pres
  - Anglo-Norman, for “so near”
- Equitable Deviation
  - “Cy pres lite”
- UMIFA/UPMIFA

7

“OLD” UMIFA

- Uniform Management of Institutional Funds Act
- “Uniform” law – promulgated by NCCUSL in 1972
- Adopted in 47 states, including Washington and Oregon

8

"NEW" UPMIFA

- Uniform Prudent Management of Institutional Funds Act
- Adopted by NCCUSL in July 2008
- Adopted in 48 states, including Oregon and Washington
- Pending in two states (Mississippi and Pennsylvania)

9

UPMIFA

- Applies to "institutional funds"
  - Fund held by institution for its own use
  - Includes endowment funds
  - Includes "component funds" at community foundation (?)
- Does not apply to:
  - Most charitable trusts
  - "Program-related assets"

10

"Goodies" in UMIFA

- Standard of care for investment decisions
- Power to delegate investment management
- "Appropriation for expenditure"
- Release or modification of restrictions

11

Standard of Care

- Prudent Investor Rule (like UPIA)
- Similar to "business judgment" rule
- "In good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances"

12

Power to Delegate

- Duty to delegate
  - To committees or officers
  - To investment advisors or agents
- Standard of care applies to delegation
- Process-driven; not product-driven

13

Effect of Prudent Investor Rule

- Modern portfolio theory
- No single investment is imprudent per se
- First duty: protect real value of portfolio
  - Old rule: protect nominal value
  - "Return of principal is more important than return on principal"

14

Effect of Prudent Investor Rule

- Risk is necessary
  - But not uncompensated risk
- In larger portfolios, risk and volatility can be reduced with “alternative investments”
  - e.g., venture capital, hedge funds, distressed securities
- Increased importance of investment policies
  - Asset allocations
  - Investment for “total return”

15

UMIFA: Expenditure of “net appreciation”

- Board may expend “net appreciation” in fund value over “historic dollar value”
- Subject to standard of care (prudence)

16

UMIFA: Expenditure of "net appreciation"

- Applies even to "endowment" funds, unless donor otherwise directs
  - Not implied from "net income" or similar restriction
- Basis for "percentage payout" funds

17

UMIFA: "Upside-Down" Funds

- Current value less than historic dollar value
- Propriety of distributions
  - Percentage payout
  - Net income
- Unhappy donors!
- Effect of gift instrument (fund agreement)

18

UPMIFA: "Appropriation for Expenditure"

- Board may "appropriate for expenditure so much of an endowment fund as the [board] determines is prudent"
  - Subject to standard of care (prudence)
- No "historic dollar value" floor
- No "upside down" problems

19

UPMIFA: Presumption of Imprudence

- Expenditure of more than **7 percent** of fund creates "rebuttable presumption of imprudence"
  - Based on value of fund assets averaged over "not less than three years"
  - **Optional** provision – included in Oregon UPMIFA at insistence of AG
  - No "presumption of prudence" for payout of less than 7 percent
- FAS treatment?!

20

Release or Modification of Restrictions

- UMIFA: Permits **release** of restrictions
- UPMIFA: Permits **release or modification** of restrictions

21

Release or Modification of Restrictions

- Board may release or modify restrictions with consent of donor(s)
- If donor consent unavailable:
  - Court order
  - Notice to AG
  - Management/investment restriction must be "impracticable or wasteful" or, because of unanticipated circumstances, modification will further the purposes of the fund
  - Charitable **purpose** may be modified only if restriction is "unlawful, impracticable, impossible to achieve or wasteful"

22

Release or Modification of Restrictions

- Board may release or modify restriction if:
  - Fund value less than $25,000,
  - Fund is at least 20 years old,
  - Notice to AG, and
  - Institution uses the fund assets "in a manner consistent with the charitable purposes expressed in the gift instrument"
  - Optional provision – included in Oregon

23