

## **An Introduction to the Law of Endowments (The Uniform Management of Institutional Funds Act)**

**Erik Dryburgh**

### **I. What Is An Endowment?**

- To a donor, an endowment is a sum of money given to a charity for charitable purposes, with only the “income” being spent and “principal” being preserved.
- To an accountant, it is a fund which is “permanently restricted”.
- To a lawyer, it is an institutional fund not wholly expendable on a current basis under the terms of the gift instrument.
- Thus, a “true” endowment is one established or created by the donor. A board-restricted endowment (or “quasi-endowment”) is created when the board takes unrestricted funds and imposes a spending restriction.

### **II. What Is UMIFA?**

- A. UMIFA is a uniform law which provides rules regarding how much of an endowment a charity can spend, for what purpose, and how the charity should invest the endowment funds. UMIFA has been adopted by 46 states (actually 47 – it has also been adopted in Arizona). Note that individual state statutes may vary from Uniform Law text. UMIFA was adopted in California effective July 1, 1991 (January 1, 1974, for educational organizations accredited by the Association of Western Colleges and Universities).
- B. UMIFA covers more than just endowments – it applies to all “institutional funds” (i.e., funds held by a charity for its exclusive use).

### **III. Why Was UMIFA Adopted?**

Charities and their lawyers were unsure how to define “income” in the context of an endowment. Many looked to trust law, which generally defines “income” as

including interest, dividends and the like, but defines gains as “principal”. Thus, charities invested endowments in bonds and high-dividend stocks, but passed by investments with favorable growth prospects if they had a low current yield. Consequently, long-term yield suffered.

“[T]oo often the desperate need of some institutions for funds to meet current operating expenses has led their managers, contrary to their best long-term judgment, to forego investments with favorable growth prospects if they have a low current yield. [I]t would be far wiser to take capital gains as well as dividends and interest into account in investing for the highest overall return consistent with the safety and preservation of the funds invested. If the current return is insufficient for the institution’s needs, the difference between that return and what it would have been under a more restrictive policy can be made up by the use of a prudent portion of capital gains.”

(Ford Foundation Report: Cary and Bright, *The Law and The Lore of Endowment Funds*, p. 5-6 (1969))

#### IV. What Are The Definitions I Need To Be Concerned With Under UMIFA?

- A. **Institution:** “an incorporated or unincorporated organization organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes....”
- B. **Institutional fund:** “a fund held by an institution for its exclusive use, benefit, or purposes, ....”
- C. **Endowment fund:** “an institutional fund, or any part thereof, not wholly expendable by the institution on a current basis under the terms of the applicable gift instrument.”
- D. **Gift instrument:** “a will, deed, grant, conveyance, agreement, memorandum, writing, or other governing document (including the terms of any institutional solicitations from which an institutional fund resulted)....”
- E. **Historic dollar value:** “the aggregate fair value in dollars of (1) an endowment fund at the time it became an endowment fund, (2) each subsequent donation to the endowment fund at the time it is made, and (3) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the endowment fund.”
- F. **Governing Board:** “the body responsible for the management of an institution or of an institutional fund.”

## V. How Does an Endowment Get Created?

- A. An endowment fund is a fund “not wholly expendable by the institution on a current basis under the terms of the applicable gift instrument”. A gift instrument is “a will, deed, grant, conveyance, agreement, memorandum, writing, or other governing document (including the terms of any institutional solicitations from which an institutional fund resulted)....”
- B. Thus, a donor can create an endowment via his/her will, trust, gift deed, etc. The charity can create an endowment, either by soliciting for endowment gifts or (more proactively) by creating its endowment fund, with desired terms, via board resolution.

## VI. How Much Of An Endowment Can A Charity Spend?

- A. “The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, both realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent ....” Net appreciation includes realized gains and unrealized gains.
- B. Although UMIFA does not explicitly so state, “income” (e.g., interest and dividends) may be spent as well.
- C. The board’s appropriation for expenditure must be “prudent”: UMIFA requires the board to “act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use...”, and states that the board shall consider (among other factors) the long- and short-term needs of the institution, its present and anticipated financial requirements, and general economic conditions.
- D. Pursuant to UMIFA donors can limit the expenditure of net appreciation but it must be *explicit*. Generally, if a donor states that the charity can spend “income/interest/dividends/etc.”, that alone does *not* impose a restriction on the expenditure of net appreciation.
- E. A charity can expand the spending limitations by carefully crafting the terms of its endowment (UMIFA sets forth a “default” rule). Many charities adopt a flexible Spending Rule based on a percentage of the fund’s average market value.

## VII. What About Purpose Restrictions?

The purpose of an endowment can be as broad as, or narrower than, the charitable purposes of the organization. Purpose is established via language in the donor’s

gift instrument, the charity's solicitation material, and the charity's governing documents.

### **VIII. What About Changing the Spending or Purpose Restrictions?**

With written consent of the donor, a charity may release a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund. If a donor is not available, by reason of death, disability, etc., the charity may petition the Probate Court for release of a restriction; if the court finds that the restriction is *obsolete or impracticable*, it may release the restriction, but may not change an endowment fund to a fund that is not an endowment fund.

### **IX. What About Enforcing the Spending or Purpose Restrictions?**

- A. What if the donor believes the institution is violating the use restriction? Some states have held that unless the donor reserves a right to enforce in the gift instrument, only the state Attorney General has legal standing (*Carl Herzog Foundation v. University of Bridgeport*, 699 A2d 995 (1997)). Other states have concluded that a donor does have standing (*LB Research and Education Foundation v. UCLA Foundation*, (June 15, 2005 decision of California Court of Appeals); *Smithers v. St. Luke's Roosevelt Hospital Center*, 723 NYS2d 426 (2001)).
- B. Consider building donor standing into the gift instrument. A power of reversion is likely to render the gift incomplete and non-deductible for income tax purposes, but a power to re-direct the gift to another charity willing to abide by the restrictions should work.

### **X. How Should A Charity Invest Its Endowment?**

- A. Investment is a matter of state law. In California, the Board is subject to the rules on prudent investments as set forth in both the Corporations Code and UMIFA (which unfortunately are not entirely consistent).
- B. The Corporations Code provides that in making investments, a Board must "avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety of funds." This is an "old fashioned" and fairly conservative statement of the prudent investor rule.
- C. UMIFA articulates the modern portfolio theory of prudent investment. It provides that the Board may invest in real or personal property mortgages, deeds of trust, stocks, bonds, debentures, and other securities. It may participate in a pooled income fund, mutual fund, or other forms of common funds.

- D. UMIFA also provides a standard of care in investing, which is comparable to the modern prudent investor rule:

“When investing . . . and delegating investment management for the benefit of an institution, the members of the governing board shall act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the institution. In the course of administering the fund pursuant to this standard, individual investments shall be considered as part of an overall investment strategy.

In exercising judgment under this section, the members of the governing board shall consider the long- and short-term needs of the institution in carrying out its . . . purposes, its present and anticipated financial requirements, expected total return on its investments, general economic conditions, the appropriateness of a reasonable proportion of higher risk investment with respect to institutional funds as a whole, income, growth, and long-term net appreciation, as well as the probable safety of funds.”

## **XI. What About Those Accountants?**

For accounting purposes, funds received as “true” endowments are classified as permanently restricted. Funds subject to a restriction which the board can satisfy – such as a timing restriction or purpose restriction – are classified as temporarily restricted. Funds received with no donor-imposed restrictions are classified as unrestricted.

FASB 124 requires that distributions from the endowment, and losses suffered by the endowment, be taken from the unrestricted asset class. Put another way, the reported value of the “true” endowment (or “permanently restricted” funds) remains at the sum of the value of the gifts/bequests on the dates of transfer, and all gains, losses, income, distributions, etc. impact the unrestricted asset class. If the endowment losses are large enough, the reported value of the unrestricted assets can be artificially low.