

The New Uniform Prudent Management of Institutional Funds Act

Wider Discretion and Greater Risks for Managers of Endowment Funds

by Lori I. Mayer

Effective June 10, 2009, the New Jersey Legislature adopted the Uniform Prudent Management of Institutional Funds Act (referred to in this article as the new act)¹ to govern charitable endowment funds, thereby repealing the Uniform Management of Institutional Funds Act (referred to in this article as the old act),² which had governed charitable endowment funds since 1975. In broad summary, these statutes govern the management and expenditure of assets by funds established to exist on a long-term basis as a source of money to further charitable purposes.

The one major change effected by the new act is to establish, as the *sole* standard for the appropriation of funds from an endowment fund, a requirement that charitable fund managers act with the care that an ordinarily prudent person in a like position would exercise under similar circumstances. This 'prudent man' standard of the new act replaces the old act's combination of a general prudent man standard and a bright-line, inflexible requirement that a charitable endowment fund retain on hand at all times assets with a total value equal to 'historic dollar value,' defined, in effect, as the total sum of all contributions to the fund.³ This change provides endowment fund managers with wider discretion to pursue the charitable purposes of their organizations, but, by eliminating the only firm standard governing endowment fund expenditures, inserts uncertainty into the propriety of less-than-conventional courses of action.

The economic conditions of the past year have simultaneously resulted in substantial decreases in the value of many charitable endowment funds and substantial increases in the need for the services provided through those endowment funds. The managers of many charitable endowment funds currently are being forced to choose between preserving prior levels of charitable services and preserving their endowments; they can

accomplish one or the other, but not both. If they reduce or completely halt endowment fund spending, the endowment fund will be preserved for the future, but the fund will not be able to sustain prior levels of charitable services. If they increase endowment fund spending to meet the increased social needs that have resulted from the current economic downturn, the endowment fund might be permanently depleted.

Unfortunately, the new act provides no additional guidance to the fund managers who are making this type of difficult decision.

In addition to removing the requirement that endowment funds retain on hand assets with a value not less than historic dollar value, the new act clarifies some issues that were not specifically addressed by the old act, and eases the process for amendment of donor restrictions. However, with the exception of the elimination of requirements related to historic dollar value, the new act does not represent a major departure from prior law. The new act is virtually identical to the Uniform Prudent Management of Institutional Funds Act as proposed by the National Commissioners on Uniform State Laws, although it does not include an optional provision of the new uniform act that would have created a presumption of imprudence if a charity spent more than seven percent of an endowment fund in any one year.

Stock Market Crash as an Impetus for Passing the New Act

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) was formally proposed by the National Commissioners on Uniform State Laws in a July 2006 report,⁴ as a successor to the Uniform Management of Institutional Funds Act (UMIFA), which had been formally proposed by the national commissioners in 1972.⁵ The national commissioners' report on the UPMIFA lists numerous criticisms of the his-

toric dollar value requirement of the UMIFA,⁶ on which New Jersey's old act was based. These criticisms include:

- historic dollar value depends on the timing of a donation, and therefore is arbitrary;
- general increases in fund values as a result of inflation can make the historic dollar value standard meaningless as a protective measure when applied to endowment funds that have been in existence for long periods of time; and,
- because many believe the historic dollar value standard does not prevent expenditure of accounting income, the standard might distort an endowment fund's investment policies and lead it to invest for income rather than on the total return basis that many consider the best method of maintaining long-term value.⁷

While all of these criticisms are justified, a major impetus for New Jersey's adoption of the new act was the stock market crash that occurred in the fall of 2008. The decline in endowment fund values caused by the crash, combined with the historic dollar value limitation of the old act, created major difficulties for charitable institutions located in New Jersey and other states where endowment funds were governed by statutes based on the old UMIFA.

Some funds, and particularly funds that had received substantial donations during the market bubble, were prohibited by the historic dollar value requirement from appropriating further funds for expenditure. Earlier this year, Cynthia Rowland, in an article in *Business Law Today*, stated that, based on normal growth and investment assumptions, a fund governed by a statute similar to the UMIFA that had been funded at the height of the market and had lost 30 percent of its value after Dec. 31, 2007,

could not be expected to return to historic dollar value, and therefore could not be expected to be authorized to spend money for its charitable purposes, until 2018.⁸

Types of Funds Governed by the Acts

The old act and new act govern 'endowment funds,' which, in general, are funds given to a charitable institution⁹ under a 'gift instrument' that prohibits the immediate and complete expenditure of the gift.¹⁰ Neither statute applies to funds managed by corporate or individual trustees,¹¹ and the new act also does not apply to 'program-related assets,' that is, assets such as a university's buildings, laboratories, and dormitories, or a soup kitchen's building and equipment, that are used to carry out a charity's purposes.¹²

In addition, the new act clarifies that a restriction on expenditure created by the charity itself after funds are received on an unrestricted basis does not convert funds into endowment funds governed by the statute.¹³

A gift instrument is the documentation under which property is transferred to or held by an endowment fund, and, in appropriate circumstances, includes the solicitation materials that led to the donation.¹⁴ A gift instrument also might include the bylaws of an institution, minutes of the board of directors, or canceled checks, but only if both the donor and the institution were or should have been aware of their terms at the time the donor made the gift.¹⁵

Appropriation Versus Expenditure

The old act and new act impose restrictions on the amount an endowment fund can 'appropriate for expenditure.'¹⁶ This raises the question of whether endowment fund managers are obligated to revisit earlier decisions to spend money in light of the conditions existing at the time the funds are paid out in compliance with earlier spending commitments.

The distinction between 'appropriation for expenditure' and 'expenditure' is not addressed in the statutes or in case law, nor is it addressed in the National Commissioners on Uniform State Laws' reports on the UMIFA and UPMIFA, which sometimes seem to assume the terms are synonymous.¹⁷ However, the New York Attorney General's Office issued a publication¹⁸ indicating that, under New York's version of the UMIFA (which remains in effect), there is a difference between 'appropriation' of funds and 'expenditure' of funds. This publication states that, if funds are appropriated at a time when their immediate use is permitted under the statute, the funds may be spent even though subsequent market fluctuations result in the actual expenditure of the funds causing endowment fund value to drop below historic dollar value.

In a recent article in *Business Law Today*, authors Susan E. Budak and Susan N. Gary, without citing any supporting authority, flatly state that, under the UPMIFA:

Whether an appropriation for expenditure is prudent is determined at the time the appropriation is made, even though there may be a delay between the time of the appropriation and the actual spending of the resources. If the charity prudently appropriates a portion of an endowment fund, it can expend the appropriated amount even if the value of the endowment is further reduced by market declines before the amount is spent.¹⁹

The position taken by the New York Attorney General's Office, and in the foregoing *Business Law Today* article, that re-evaluation of spending commitments is not required as those commitments are met, seems reasonable. Equating appropriation of funds for expenditure with expenditure of funds would be inconsistent with the plain meaning of

the statutes. In addition, imposing restrictions on appropriation of funds, but not on expenditure of funds after a commitment has been made for their expenditure, makes sense from a public policy point of view, especially in the context of a charitable organization.

Charities often make commitments in advance to fund various projects. Requiring a charity to refuse to honor a commitment to a third party or to cancel its own projects as a result of market fluctuations, would be disruptive to long-term planning by the providers of charitable services. Finally, requiring a charity to double-check the state of its endowment each time a check is written would create an administrative burden. Nevertheless, whether, under certain market conditions, 'prudence' requires re-evaluation of spending commitments made in more prosperous times is not clearly addressed by the new or the old act.

Standards for Expenditure of Funds

The old act contained a dual requirement for decisions by the governing body of a charitable endowment fund to appropriate funds for expenditure. The old act contained a general requirement that the governing body "exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the...decision," and "consider 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, price level trends, and general economic conditions,"²⁰ and the objective, bright-line historic dollar value limitation that prohibited appropriations for expenditure if the endowment fund did not have on hand assets with a value equal to the aggregate value in dollars of all contributions to the fund.²¹

The new act establishes the following standard, derived from the Prudent Investor Act,²² for appropriation of funds for expenditure by a charitable endow-

ment fund:

Subject to the intent of a donor expressed in the applicable gift instrument, an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established....In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following factors:

- (1) the duration and preservation of the endowment fund;
- (2) the purposes of the institution and the endowment fund;
- (3) general economic conditions;
- (4) the possible effect of inflation or deflation;
- (5) the expected total return from income and the appreciation of investments;
- (6) other resources of the institution; and
- (7) the investment policy of the institution.²³

The new act clarifies that, in the case of a conflict between the gift instrument under which funds are donated and the spending restrictions imposed by statute, the gift instrument controls.²⁴ However, both the new act and the old act negate donor directions to use only "income," "interest," "dividends," or "rents, issues, or profits," or "to preserve the principal intact," and provide that these types of limitations are deemed to constitute a direction to expend money as permitted by the statute.²⁵

How Does an Endowment Board Spend Money Prudently?

While the 2006 report of the National Commissioners on Uniform State

Laws²⁶ and various materials available at the national commissioners' website²⁷ claim the UPMIFA provides stricter guidelines on spending than the old UMIFA, that claim is dubious. Both statutes provide essentially the same list of factors to be considered by an endowment fund in determining how much money to appropriate for expenditure, both incorporate modern concepts of 'total return investing' in the list of factors, and both require the managers of the fund to act prudently in making their determinations. The truth is, by removing the bright-line historic dollar value cap on appropriations, the UPMIFA provides less guidance to fund managers than the UMIFA.

In a recent article in the American Bar Association magazine *Business Law Today*,²⁸ attorney Cynthia Rowland pointed out:

[T]he spending policy factors of UPMIFA [include] ... 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 earning 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 interest of the public.

The new act does not include an optional provision of the UPMIFA that would have created a rebuttable presumption of imprudence if a charity "appropriate[ed] for expenditure in any year...an amount greater than seven percent of the fair market value of an endowment fund, calculated on the basis of market values 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." This provision, or a variation of it, has been enacted in at least nine states.

All nine states included the seven-percent limitation of the UPMIFA in their statutory rebuttable presumptions of imprudence, although the Texas statute lowers the limit to five percent for endowment funds worth less than \$1 million and raises it to nine percent for certain educational institutions, and the California statute exempts certain educational institutions.²⁹ In addition, the Ohio version of the UPMIFA creates an *irrebuttable* presumption of *prudence* for "[t]he appropriation for expenditure in any year of an amount not greater than five per cent of the fair market value of an endowment fund...calculated on the basis of market values that are 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 was made."³⁰

The new act does not prescribe how, or how frequently, the governing body of a New Jersey endowment fund should value assets. In this regard, the New York Not-for-Profit Corporation Law, which includes provisions based on the old UMIFA (and therefore retains a cap on appropriations based on historic dollar value) requires only an annual analysis of an institution's endowment funds.³¹ However, all of the states that enacted the UPMIFA's optional presumption regarding imprudence, or a variation of it, included in their statutes the UPMIFA provision that bases the presumption on "market values 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."

Notwithstanding the New Jersey Leg-

islature's decision to not enact the UPMIFA's statutory presumption regarding imprudence, managers of New Jersey endowment funds might want to take the statutory presumptions of the states that enacted this provision into account in deciding how to value endowment fund assets, in making decisions regarding spending commitments, and, possibly most important, in documenting the reasons for their decisions to deviate from the presumptions.

Does Enactment of the New Act Eliminate the Need to Cure Violations of the Historic Dollar Value Requirement of the Old Act?

While the new act is retroactive in the sense that it applies to endowment funds established before its effective date, it does not apply to decisions made or actions taken by endowment fund managers before the new act went into effect.³² The new act does not absolve managers of older endowment funds from any obligations that might have arisen as a result of prior violations of the historic dollar value requirements of the old act, nor does it give any indication whether managers, in their discretion, can decide to ignore that such a violation occurred.

Neither the old act nor the old UMIFA provided guidance to managers of an endowment fund that no longer possessed assets worth historic dollar value, or that had violated the historic dollar value restriction. The New York attorney general³³ has taken the position that an institution has an affirmative duty to restore money that was 'appropriated' from an endowment fund in violation of the historic dollar value limitation.³⁴ It has been suggested that violations of the historic dollar value limitation can be cured by 'donating' accounting income from restricted funds, or by 'donating' unrestricted funds, to the 'underwater' endowment fund.³⁵ Violations also can be addressed

by obtaining the consent of the donor to a release from the statutory restrictions.

Under the new act, the decision of managers of an endowment fund to cure or ignore past violations of the historic dollar value requirement presumably falls within the general prudent man standard of the new act. If, in exercising the discretion granted to them under the new act, fund managers determined to appropriate funds in a manner that would cause the value of the fund to fall below historic dollar value, it would seem to make no sense for them to have an obligation to restore historic dollar value before removing the funds as permitted by the new act.

The greater discretion granted to endowment fund managers under the new act is one more step in a historical pattern of gradual and continuous expansion of the discretion granted to trustees and other fiduciaries.³⁶ Consistent with this pattern, under the new act, managers of charitable endowment funds have wider latitude to apply funds to effectuate the endowment funds purposes and goals, but also greater risks that their decisions will be challenged or condemned. ▽

Endnotes

1. N.J.S.A. 15:18-25 *et seq.*
2. N.J.S.A. 15:18-15 *et seq.*
3. N.J.S.A. 15:18-28.
4. Uniform Prudent Management of Institutional Funds Act drafted by the National Commissioners on Uniform State Laws and by it approved and recommended for enactment in all the states at its annual conference meeting at Hilton Head, South Carolina, July 7-14, 2006, *available at* www.law.upenn.edu/bll/archives/ulc/umoifa/2006final_act.pdf.
5. Uniform Management of Institutional Funds Act drafted by the National Commissioners on Uni-

form State Laws and by it approved and recommended for enactment in all the states at its annual conference meeting at San Francisco, California, Aug. 4-11, 1972, at 8, available at www.law.upenn.edu/bll/archives/ulc/fnact99/1970s/umifa72.pdf (referred to in this article as the national commissioners' 1972 report).

6. Available at www.law.upenn.edu/bll/archives/ulc/fnact99/1970s/umifa72.pdf.
7. See national commissioners' 2006 report at 3-4. Regarding expenditure of accounting income when the value of an endowment fund has fallen below historic dollar value, that position is endorsed by a publication issued by the office of the New York attorney general. The document, originally titled "New York State Attorney General Eliot Spitzer Advises Not-For-Profit Corporations on the Appropriation of Endowment Fund Appreciation," and subsequently retitled "Advice for Not-For-Profit Corporations on the Appropriation of Endowment Fund Appreciation," was available at www.oag.state.ny/bureaus/charities/pdfs/endowment.pdf. As of the writing of this article, the document could not be retrieved from the website even though other materials available at the website contain links to that location. See also, Budak, Susan E. and Gary, Susan N., Legal and Accounting Challenges of Underwater Endowment Funds, *Business Law Today*, Volume 24, Number 1, January/February 2010, at 28 and 30 (Stating initially, that the old uniform act "does not discuss the spending of income, and it was thought that a charity could continue to spend interest, dividends, rents, and royalty income, even if the value of the fund fell below historic dollar value" and later, that, under the old uniform act, an underwater fund can

spend "only interest, dividends, rents, and royalty income.")

8. Rowland, Cynthia R., UPMFIA, Three Years Later: What's a Prudent Director to Do?, *Business Law Today*, Volume 18, Number 6, July/August 2009.
9. Generally, the new act applies to an organization whose purpose is "the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of a governmental purpose, or any other purpose, the achievement of which is beneficial to the community," N.J.S.A. 15:18-26, and, the old act applied to an organization "organized and operated exclusively for educational, religious, charitable, hospital or other eleemosynary purposes, or a governmental organization to the extent that it holds funds exclusively for any of these purposes," N.J.S.A. 15:18-15.
10. "Endowment fund" is defined in the new act, N.J.S.A. 15:18-26, as "an institutional fund or any part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis." The definition of this term in the old act, N.J.S.A. 15:18-15(c), was almost identical: "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."
11. N.J.S.A. 15:18-26; see also national commissioners' 2006 report at 2.
12. N.J.S.A. 15:18-26. See also "Program Related Assets Under UPMIFA," available at www.upmifa.org/Uploads/UPMIFA_ProgramRelatedAssets.pdf.
13. The definition of "endowment fund" in the new act, N.J.S.A. 15:18-26, specifically states: "The term does not include assets that an institution designates as an endowment fund

for its own use." However, since under the old act, N.J.S.A. 15:18-15(c), a fund was not an endowment fund unless restrictions on expenditure were imposed "under the terms of the applicable gift instrument," it follows that post-donation, internally created restrictions would not have turned donated funds into endowment funds subject to the old act. See also national commissioners' 1972 report at 8 ("If a governing board has the power to spend all of a fund but, in its discretion, decides to invest the fund and spend only the yield or appreciation therefrom, the fund does not become an endowment fund.").

14. The new act, N.J.S.A. 15:18-26, defines "gift instrument" 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," and defines "record" as "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form." The old act, N.J.S.A. 15:18-15(f), defined "gift instrument" as "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) under which property is transferred to or held by an institution as an institutional fund."
15. National commissioners' 2006 report at 8.
16. Old act, N.J.S.A. 15:18-16; new act, N.J.S.A. 15:18-28.
17. For example, the national commissioners' comment to Section 2 of the old UMIFA, which governs when an endowment fund's "governing board may appropriate for expenditure," states: "This section authorizes a governing board to expend for purposes

- of the fund the increase in value of an endowment fund over the fund's historic dollar value." See national commissioners' 1972 report at 9. Similarly, the national commissioners' comments to Section 4 of the new UPMIFA, which sets forth the conditions under which "an institution may appropriate [funds] for expenditure," states: "Section 4 permits expenditures from an endowment fund to the extent the institution determines that the expenditures are prudent after considering the factors listed in subsection (a)." See national commissioners' 2006 report at 22.
18. See note 4.
 19. Budak, Susan E. and Gary, Susan N., Legal and Accounting Challenges of Underwater Endowment Funds, *Business Law Today*, Volume 24, Number 1, January/February 2010, at 30.
 20. N.J.S.A. 15:18-20.
 21. N.J.S.A. 15:18-16. The term "historic dollar value" was defined in N.J.S.A. 15:18-15(e).
 22. N.J.S.A. 3B:20-11.1 *et seq.*
 23. N.J.S.A. 15:18-28.
 24. The new act specifies that its restrictions on spending are "[s]ubject to the intent of a donor expressed in the applicable gift instrument." N.J.S.A. 15:18-28(a). The old act was less clear on the issue: The old act stated that, notwithstanding the provisions of the old act, the expenditure of capital gains was not permitted if "the applicable gift instrument indicates the donor's intention that net appreciation shall not be expended," N.J.S.A. 15:18-17, but did not specifically state that a "gift instrument" could authorize the expenditure of funds above and beyond that permitted by the old act.
 25. New act, N.J.S.A. 15:18-28(c); old act, N.J.S.A. 15:18-17.
 26. See national commissioners' 2006 report at 2.
 27. See, e.g., "Uniform Prudent Management of Institutional Funds Act – A Summary," available at www.nccusl.org/Update/uniformact_summaries/UPMIFA_Summary.pdf.
 28. Rowland, Cynthia R., UPMFIA, Three Years Later: What's a Prudent Director to Do?, *Business Law Today*, Volume 18, Number 6, July/August 2009.
 29. See California Probate Code Section 18504(d) (rebuttable presumption at 7%; presumption does not apply to postsecondary educational institutions or to campus foundations established by and operated under the auspices of such an educational institution); Maryland Code Section 15-403(d) (rebuttable presumption at 7%); Montana Code Section 72-30-209(4) (rebuttable presumption at 7%); Nevada Revised Statutes Section 164.667(4) (rebuttable presumption at 7%); New Hampshire Statutes Section 292-B:4.VI. (rebuttable presumption at 7%); North Dakota Century Code Section 59-21-03(4) (rebuttable presumption at 7%); Oregon Revised Statutes Section 128.322(4) (rebuttable presumption at 7%); Texas Statutes Section 163.005 (rebuttable presumption at 7% for endowment funds with an aggregate value of \$1 million or more, at 5% for endowment funds with an aggregate value of less than \$1 million, and at 9% for "a university system" with "an endowment fund with an aggregate value of \$450 million or more; separate endowment funds of the same institution that are pooled for collective investment are considered a single fund for these purposes); Tennessee Code Section 35-10-204(d) (rebuttable presumption at 7%); Utah Code Section 51-8-304 (rebuttable presumption at 7%).
 30. Ohio Revised Code 1715.53(D).
 31. New York Not-for-Profit Corporation Law, Section 513(b).
 32. N.J.S.A. 15:18-32.
 33. See note 4.
 34. Similarly, the materials from a 2004 ALI-ABA course on museum administration indicate that the authors do not believe there is an obligation to restore historic dollar value if an endowment fund falls below historic dollar value due to market depreciation and not due to an "invasion." See materials from ALI-ABA Course of Study, March 24-26, 2004, Legal Problems of Museum Administration, at 168-169.
 35. More dubious suggestions for restoring historic dollar value include using unrestricted funds to restore historic dollar value under an agreement that the contribution will be returned when historic dollar value has been recovered and using unrestricted funds to restore historic dollar value but putting the new funds in escrow. See materials from ALI-ABA Course of Study, March 24-26, 2004, Legal Problems of Museum Administration, at 169-170. The Massachusetts attorney has indicated that, because, the Massachusetts version of the old uniform act (like the New Jersey old act), allows "endowment funds" to be appropriated only "for expenditure," they cannot be appropriated to build up reserves if current expenditure is not reasonably anticipated. AGO Position on FASB Statement of Financial Accounting Standards No. 117 Paragraph 22 and Related M.G.L. c. 180A Issues, available at www.mass.gov/?pageID=cagohomepage&L=1&LO=Home&sid=Cago.
 36. See, e.g., *Fidelity Union Trust Co. v. Price*, 11 N.J. 90, 95-96 (1952).

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