Tax-Exempt Organizations

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New York Version of UPMIFA Creates Flexibility as well as New Burdens for Nonprofits

UPMIFA has finally come to New York, but with unique features that present significant challenges and burdens for the state's nonprofit organizations.

Governor David Paterson signed New York's version of UPMIFA into law on September 17, 2010. New York organizations are now subject to a new standard of prudence governing the investment of institutional funds, and they have gained new flexibility in making appropriations from endowment funds. Organizations lobbied hard for the new statute, in part because it will provide them the ability, in appropriate cases, to spend from an endowment fund that is "underwater" – that is, worth less than the value of the gifts with which the fund was created.

UPMIFA is the Uniform Prudent Management of Institutional Funds Act, a model act promulgated by the Uniform Law Commission and since adopted by 46 other states and the District of Columbia. New York's version of UPMIFA, or NYPMIFA, follows the uniform act in its essentials, but differs from it in significant ways. Because many readers are familiar with UPMIFA generally, this article focuses on the ways that NYPMIFA is *different* from the norm. For a brief summary of UPMIFA fundamentals, please go to the Appendix on page 8.

NYPMIFA generally applies (a) to not-for-profit corporations and (b) to those wholly charitable trusts where the *trustee* is a not-for-profit corporation. Wholly charitable trusts where the trustee is an individual or a corporate fiduciary are generally (but not entirely) outside the scope of NYPMIFA. Significantly, NYPMIFA is not limited to not-for-profit corporations with exclusively charitable purposes, commonly known as Type B corporations and ordinarily classified as Section 501(c)(3) organizations under the Internal Revenue Code. Rather, NYPMIFA applies even to *non-charitable* not-for-profit corporations (that is, Type A, Type C and Type D corporations), which may be classified for tax purposes as social welfare organizations (Section 501(c)(4) organizations), business leagues and trade associations (Section 501(c)(6) organizations), and social clubs (Section 501(c)(7) organizations).

Organizations typically look to the state where they are organized for the laws governing their internal affairs, such as the management of investments and the appropriation of endowment funds. Although New York's not-for-profit corporation law contains provisions expressly applying a few of its sections to non-New York organizations that conduct activities in New York, no provision of that type is included in NYPMIFA. Accordingly, it does not appear that NYPMIFA applies to non-New York corporations conducting activities in New York State.

NYPMIFA presents six key action items for organizations covered by it, four having to do with endowment fund appropriations and two pertaining to prudent investing of institutional funds. All of these items are discussed in greater detail after this brief summary.

Making Appropriations from Endowment Funds

1) *Communicating with "Available" Donors*. Generally speaking, if the donor to an endowment fund is still available and the endowment fund is governed by a gift instrument executed by the donor before September 17, 2010, an organization may not make an appropriation under NYPMIFA unless a statutory notice procedure is followed or a specific agreement is reached with that donor. Therefore, for endowment funds of this type, organizations that want the full flexibility provided by NYPMIFA should develop a protocol either for sending an appropriate notice to available donors or for working with available donors to develop mutually agreeable terms for making appropriations in light of the new law.

2) *Documenting Appropriation Decisions*. Because NYPMIFA requires documentation of decisions to make an appropriation from an endowment fund, organizations should develop a system for (a) analyzing the eight statutory factors that must be considered before making the appropriation and (b) documenting the consideration given to each factor.

3) *Addressing the Presumption of Imprudence*. For new endowment fund gifts, organizations should consider whether and how to modify their forms of gift agreement to limit the effect of the presumption of imprudence now applicable to the appropriation during the year of more than 7% of the value an endowment fund created under an instrument executed on or after September 17, 2010.

4) *Updating Endowment Fundraising Materials*. Organizations should update their endowment fundraising materials to include new language required by NYPMIFA.

Prudent Investing of Institutional Funds

5) *Updating Investment Policies.* Because an organization is now required to have an investment policy meeting certain statutory standards, organizations should review existing policies to confirm compliance. An organization with no investment policy must develop one that is consistent with NYPMIFA's requirements.

6) *Assessing the Independence of Agents*. An organization that delegates the management or investment of assets to third-party agents should develop a protocol for assessing the agents' independence.

Provisions Governing Appropriations from Endowment Funds

Opting In or Opting Out of NYPMIFA's Appropriation Regime. In its original form, UPMIFA would permit organizations to appropriate a prudent portion of any endowment fund at any point after the statute's effective date. NYPMIFA, however, creates an "opt in, opt out" feature that limits the application of the new, more flexible appropriation rules for certain existing endowment funds.

Under New York's "opt in, opt out" system, an organization may not make appropriations under NYPMIFA (in particular, appropriations that dip into the original dollar value) from any endowment fund governed by a gift instrument executed by the donor before September 17, 2010, if the donor is "then available," *unless*, at least 90 days before doing so, the organization gives the donor a form of notice containing language substantially as follows:

> Please check Box #1 or #2 below and return to the address shown above.
>
> ( )#1. The institution may spend as much of my gift as may be prudent.
>
> ( )#2. The institution may not spend below the original dollar value of my gift.
>
> If you check Box #1 above, the institution may spend as much of your endowment gift (including all or part of the original value of your gift) as may be prudent under the criteria set forth in Article 5-A of the Not-for-Profit Corporation Law (the Prudent Management of Institutional Funds Act).
>
> If you check Box #2 above, the institution may not spend below the original dollar value of your endowment gift but may spend the income and the appreciation over the original dollar value if it is prudent to do so. The criteria for the expenditure of endowment funds set forth in Article 5-A of the Not-for-Profit Corporation Law (the Prudent Management of Institutional Funds Act) will not apply to your gift.

If a donor does not respond to the notice within 90 days, or if the donor responds by checking Box #1, the organization may then avail itself of NYPMIFA's rules for making appropriations from the endowment fund created by the donor.

The New York statute does not stipulate what legal regime governs appropriation of income and appreciation *before* a notice is given and *before* a reply is received or the 90-day notice period has passed. During this window, are appropriations from the endowment fund still governed by immediately prior law permitting income and certain appreciation to be appropriated and spent if the action is prudent? Because of the disruptive effect of other possible interpretations, organizations will undoubtedly welcome confirmation by the Attorney General that this question may be answered in the affirmative.

New York's novel "opt in, opt out" feature presents numerous other interpretational questions. For example, while the statute defines an "available" donor as a donor that is living or extant (if an organization) that "can be identified and located with reasonable efforts," how much diligence must an organization conduct to meet the "reasonable efforts" standard? And even though a legally incapacitated donor might be "available" in some sense, how could such a donor complete the notice form?

Organizations face other questions as well. For example, if a donor checks Box #2, does that mean that the organization can never spend below the original dollar value of the gift, even if it appropriates the amount when the fund is "above water"? By framing the text of Box #2 and the explanation of Box #2 in terms of *spending* rather than *appropriation*, the new statute raises this issue, which is not trivial for the many organizations that appropriate funds from their endowments when the annual budget is adopted but do not spend those funds until later in the fiscal year – at which point the fund could have dropped below its original dollar value due to market declines. If a donor's decision to check Box #2 imposes greater strictures on the organization than were present even under *prior* law and assuming immediately prior law continues to apply, an organization may be better off with donor silence (or a tailor-made agreement with the donor) than using the statutory form of notice and running the risk a donor will check Box #2.

The new notice procedure is not necessary to the extent the gift instrument expressly permits spending below the original dollar value of the endowment fund. In addition, the procedure does not apply to

existing endowment funds received as part of a general institutional solicitation (so long as the donor did not further restrict the gift). Finally, the notice procedure may not be used to override specific spending restrictions set by the donor.

Organizations should be aware that NYPMIFA applies automatically, and without need of the "opt in, opt out" procedure, to endowments established by donors who are no longer "available" and to gifts established under instruments executed by the donor on or after the effective date of NYPMIFA. However, for newly created endowment funds there are new charitable solicitations requirements (described below) that affect communications with donors.

Under the new statute, the "opt in, opt out" notice is considered to have been given if it is given personally in writing or sent to the donor's last known address on record with the organization or, if no address is on record, if the organization makes reasonable efforts to attempt to find and notify the donor. If the notice is mailed, it is considered given when it is deposited in the U.S. mail with prepaid postage. Notice by fax or email is considered given when it is sent. A record of the notices and responses must be maintained, although the statute does not say for how long. In the absence of authoritative guidance, an organization may want to revise its document retention policy to require permanent retention of the copies of the notice and response.

Although organizations will undoubtedly make judgments about how to interpret New York's "opt in, opt out" rules, it is already clear that the new statute is in need of clarifying amendments from the Legislature and/or published guidance from the New York Attorney General. Nonprofits may wish to consider whether to clarify the language in the notice, whether to negotiate specific terms with specific donors in lieu of following the notice procedures, and whether to use the notice process to obtain modification of other donor restrictions, if those have become outdated or unwieldy.

Factors Affecting Appropriations from an Endowment Fund. UPMIFA enumerates seven factors that an organization must consider, if relevant, when determining the amount of an endowment fund it will appropriate. Those factors are:

(1) the duration and preservation of the endowment fund,

(2) the purposes of the organization 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 organization, and

(7) the investment policy of the organization.

A Caveat about the Notice Procedure

NYPMIFA specifically gives effect to "terms in a gift instrument setting forth a specific spending level, rate or amount, or explicitly modifying or overriding" the new law's default provisions governing appropriations from endowment funds. This means that following the "opt in, opt out" procedure is not sufficient to override a donor's specific limitation on the level, rate or amount of spending. For example, if a donor gave an organization the flexibility to appropriate and spend "a prudent portion of this endowment fund, but not more than 6% per annum of its average asset value over the preceding three years," that limitation could not be modified by sending the "opt in, opt out" notice. Instead, the donor would need to give a specific consent to the modification, or if the donor is not available to give the consent, the organization would need to obtain judicial relief under the provisions of the new law governing the release or modification of donor restrictions.

New York has added an *eighth* factor:

(8) where appropriate and circumstances would otherwise warrant, alternatives to expenditure of the endowment fund, giving due consideration to the effect that such alternatives may have on the organization.

In other words, New York appears to be mandating, in "appropriate" situations, that the prudence evaluation include a consideration of what it would mean to the organization if it elected to appropriate *nothing* from a given endowment fund or at least to appropriate less than it would ordinarily appropriate if it simply applied its endowment spending policy. This provision presumably is meant to encourage organizations to consider curtailing or even eliminating appropriations from endowment funds that, for example, have suffered market declines. Attorney General guidance on the interpretation of this provision is needed (e.g., to ascertain if this factor must be considered even when an endowment fund has appreciated in value).

Presumption of Imprudence. The uniform version of UPMIFA contains an optional provision creating a rebuttable presumption that an appropriation from an endowment fund in any year greater than 7% of its fair market value is imprudent. Most states elected not to include this presumption. New York adopted the presumption, but only with respect to gift instruments executed on or after September 17, 2010. UPMIFA requires that the fair market value of an endowment fund be calculated as a quarterly (or more frequent) average over a three-year period or the period of the fund's existence, if shorter. New York elected to make the calculation period five years or the period of the fund's existence, if shorter. For the many organizations that calculate their endowment draw using a three-year rolling average or another methodology that differs from this rule, a special NYPMIFA calculation may be necessary in order to be assured that the endowment draw will not trigger the presumption of imprudence.

According to the Uniform Law Commission commentary to UPMIFA, the presumption of imprudence does not shift the burden of proof to the charity, only the burden to produce evidence that supports the prudence of the decision to make an endowment fund appropriation in excess of the 7% rate. If New York interprets NYPMIFA in accordance with the UPMIFA commentary, the Attorney General would still bear the burden of persuading a court that an annual appropriation in excess of the 7% threshold was imprudent.

One important caveat about the presumption of imprudence: There is no "safe harbor" of prudence for appropriations of 7% or less, so organizations should not assume that the prudence of an appropriation decision is established simply by making appropriations at or below the 7% level.

Because this new presumption does not apply to an appropriation permitted under the gift instrument, organizations may wish to update their endowment gift forms to authorize appropriations that would not be subject to the presumption of imprudence. For example, the presumption will not apply to a gift instrument that permits an appropriation in any year in excess of 7% of the fair market value of an endowment fund under certain specified conditions.

Three Statutory Categories of Endowment Funds

By creating the "opt in, opt out" concept and imposing a presumption of imprudence in some cases but not all, New York has created at least three statutory categories of endowment funds, each with a different legal character. That is in addition to all the subcategories that donors choose to create through the unique conditions that they impose. Hence, the price of UPMIFA-style flexibility in New York is a significant new level of complexity for endowment funds. The statutory categories are summarized below. The flexibility introduced by the new law is greatest with respect to endowment funds in the first of these categories.

Type of Endowment Fund	*Treatment under NYPMIFA*
An endowment fund governed by a gift instrument executed by the donor before 9/17/2010, where the donor is *not* "available," or an endowment fund received before that date as part of a general institutional solicitation (so long as the donor did not further restrict the gift)	An organization may appropriate a prudent portion of the assets, without any adverse presumption if the annual appropriation exceeds 7% of fair market value and without regard to whether the appropriation consumes income, appreciation, or the original dollar value of the gift.
An endowment fund governed by a gift instrument executed by the donor before 9/17/2010 where the donor is "available"	An organization must follow the "opt in, opt out" notice described above before an appropriation under NYPMIFA can be made, or the organization must specifically negotiate mutually agreeable new terms with the donor.
An endowment fund governed by a gift instrument executed by the donor on or after 9/17/2010	An organization may make appropriations under NYPMIFA, without regard to traditional distinctions concerning income, appreciation and original dollar value, but with a presumption of imprudence if the annual appropriation exceeds 7% of fair market value. An organization must also provide the endowment fund disclosure statement now required under the charitable solicitations law.

Documenting Decisions to Appropriate. For each determination to make an appropriation from an endowment fund, New York requires a contemporaneous record describing the consideration given to each of the eight factors listed above. For an organization with dozens or even hundreds of endowment funds, many of them held for specific purposes or subject to other specific donor restrictions, this requirement may present a substantial new burden, because the rationale for spending a particular portion may not be the same in all cases. Endowment funds subject to similar or identical restrictions, however, ordinarily could be considered as a group. Organizations will need to develop a process to address this requirement. This process could include creating templates and checklists to ensure that an organization is building an adequate record.

Notifying Donors of the Power of Appropriation from Endowment Funds. Also unique to New York is a provision amending the charitable solicitations law to provide that all endowment fund solicitations "must include a statement that, *unless otherwise restricted by the gift instrument pursuant to paragraph (B) of section five hundred fifty-three of the not-for-profit corporation law, the institution may expend so much of an endowment fund as it deems prudent after considering the factors set forth in paragraph (A) of section five hundred fifty-three of the not-for-profit corporation law.*" The consequences (if any) of failing to include the italicized statement are unstated, but in any event, organizations will want to make sure that fundraising materials for endowment gifts are modified to include it.

Provisions Governing Investment Management

Investment Policy. Another unique feature of NYPMIFA is a provision requiring organizations to have a policy "setting forth guidelines on investments and delegation of management and investment functions in accord with the standards" of the new statute. Even organizations that already have written investment policies may have to update them to ensure that they are "in accord" with the prudence standard and other investment standards under the new law. (Those investment standards are described in the accompanying Appendix concerning UPMIFA.) No deadline is established for organizations to develop an appropriate investment policy. The requirement to have an investment policy appears to be applicable even to wholly charitable trusts with an individual, bank or trust company as trustee – even though such trusts are generally outside the ambit of NYPMIFA.

Selecting Agents to Whom Investment Function is Delegated. NYPMIFA establishes an affirmative duty to assess the independence of external agents selected to manage and invest institutional funds, including any conflicts of interest the agent has or may have. In addition to developing a suitable definition of conflicts of interest in this context, organizations may want to develop procedures for collecting conflicts information from agents hired to manage and invest institutional funds.

Reviewing Decisions Not to Diversify. NYPMIFA requires that an organization review at least annually (or more frequently, if circumstances require) any decision not to diversify the assets of an institutional fund.

For additional information about UPMIFA generally or about NYPMIFA, please contact any member of our Exempt Organizations practice group.

Appendix

What UPMIFA is all About

Broadly speaking, UPMIFA addresses three main topics: (1) management and investment of institutional funds; (2) appropriations from endowment funds; and (3) release of donor restrictions on institutional funds. In one form or another, UPMIFA is now the law in all states (other than Pennsylvania, Florida and Mississippi) and the District of Columbia.

Who Is Covered by UPMIFA?

UPMIFA applies to the management and investment of an "institutional fund," which means a fund held by an "institution" other than (a) assets held primarily to accomplish a programmatic purpose (and not for investment), (b) a fund held for an institution by a trustee that is not an institution (e.g., an individual or a bank), and (c) assets held for the benefit of a beneficiary that is not an institution (such as the assets of a charitable remainder trust before the non-charitable interest terminates). The term "institutional fund" expressly includes a charitable remainder trust after the non-charitable interest terminates (if the trustee is an institution) and appears to include a wholly charitable estate if the executor is an institution.

The term "institution" is defined in such a way that it includes all not-for-profit corporations as well as wholly charitable trusts. However, those funds held for an institution by a trustee that is not an institution are excluded from the definition of "institutional funds," so as a practical matter wholly charitable trusts with an individual, bank or trust company as trustee fall outside UPMIFA. Note, though, that such charitable trusts are subject to similar prudent investor rules on management and investing under the laws generally applicable to trusts (in New York, Section 11-2.3 of the Estates, Powers and Trusts Law).

UPMIFA also governs appropriations from "endowment funds." An "endowment fund" is an institutional fund (or part thereof) that under the terms of the gift instrument is "not wholly expendable on a current basis," which means that the donor has placed a restriction of some kind on the amount that can be spent from the fund. Thus, a fund that is restricted only as to purposes, but not as to the amount that may be spent, would be an institutional fund but not an endowment fund. The reason that the distinction matters is that some charities – including most private foundations – do not have endowment funds in this technical sense, which means that they will not be subject to the law's requirements concerning endowment fund appropriations (though they may wish to be informed about the law if they plan to be on the giving end of endowment grants). But all institutions, even those without endowment funds in the technical sense, need to know about the new rules governing how they manage and invest their institutional funds.

Management and Investment of Institutional Funds

UPMIFA updates prior law to bring it in line with more current conceptions of prudent investing. The duty of care imposed on those who are responsible for investment of institutional funds remains essentially the same – the care of an ordinarily prudent person in a like position under similar circumstances. But

UPMIFA establishes detailed guidelines concerning how the duty of care must be exercised. The key points to understand here are the following:

- ***Factors to Consider***: When managing and investing an institutional fund, an organization must consider, if relevant: (a) general economic conditions; (b) the possible effect of inflation or deflation; (c) the expected tax consequences, if any, of investment decisions or strategies; (d) the role that each investment or course of action plays within the overall investment portfolio of the fund; (e) the expected total return from income and the appreciation of investments; (f) other resources of the institution; (g) the needs of the institution and the fund to make distributions and to preserve capital; and (h) an asset's special relationship or special value, if any, to the purposes of the institution.
- ***Appropriate Decision-Making in Context****:* The organization must make management and investment decisions about an asset in the context of the overall portfolio as part of an overall strategy that takes into consideration risk and return objectives appropriate to the institution. The management costs incurred must also be reasonable and appropriate in relation to the assets of the organization, its purposes, and the skills available to it.
- ***Types of Assets:*** An institution may pool institutional funds for investment purposes and may invest in any kind of property or investment (unless a gift instrument says otherwise), but the institution must diversify a fund's investments unless it prudently determines that because of special circumstances the purposes of the fund are better served without diversification. (As noted in the accompanying article on the New York-specific aspects of UPMIFA, a decision not to diversify must be revisited at least once a year by institutions governed by New York law.)
- ***Delegation of Investment Management***: An organization may delegate the management and investment function to an external agent – and will not be liable for the decisions or actions of the agent – so long as it exercises prudence in (a) selecting, continuing, or terminating the agent; (b) establishing the scope and terms of the delegation; and (c) monitoring the agent. An organization may also delegate these functions to its committees, officers, or employees. (The accompanying article on New York's version of UPMIFA describes a special requirement in New York concerning the independence of agents to whom management authority is delegated.)

Endowment Spending

UPMIFA, which was adopted by the National Conference of Commissioners on Uniform State Laws in 2006, grew out of the economic downturn of 2001 and was designed to address precisely the situation facing many charities since the economic crisis of 2008, namely, underwater endowment funds. As the drafters of UPMIFA explain in their prefatory comments, the act is intended to modernize the law and also to give greater flexibility to charities in coping with fluctuations in the value of endowment funds.

Elimination of Historic Dollar Value. The most pertinent change introduced by UPMIFA in the endowment area is its elimination of the concept that historic dollar value – that is, the original dollar value of the fund plus any amounts added by the donor – may not be appropriated for expenditure. In making this change, the drafters cited, among other reasons, the rule's arbitrariness in fixing value at the time of the gift, its lack of consideration to issues surrounding inflation, and its meaninglessness as a benchmark for endowments that have grown significantly. In place of historic dollar value, UPMIFA expands the prudence standard, giving boards more guidance when making decisions to expend

endowment funds. In making a determination to appropriate or accumulate, the new standard requires the institution to "act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances" and to 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.

According to the UPMIFA drafters, these factors emphasize the importance of the intent of the donor, by which is meant donor intent "as expressed in the gift instrument," rather than the wishes expressed by the donor at the time the expenditure is made by the organization. Note that any express restrictions contained in the gift instrument – including a prohibition on spending historic dollar value – must be honored; the parameters on expenditure set forth by UPMIFA remain default rules. (An eighth factor has been added in New York, as explained in the accompanying article on the New York-specific aspects of UPMIFA. New York also limits an organization's flexibility to dip into the historic dollar value or to spend more than a certain percentage of certain endowment funds, as discussed in the accompanying article.)

Donor or Judicial Release of Restrictions

UPMIFA permits an organization's board to release an endowment restriction upon consent of the donor, as had also been the case under prior law. UPMIFA expands the circumstances under which judicial modification of the restriction is appropriate. In addition, UPMIFA introduces a provision that permits an institution to release or modify a restriction on an endowment fund *without* court approval, upon 60 days' notice to the Attorney General, in instances where the fund's value is less than $100,000, more than 20 years have elapsed since its establishment, and the property will be used consistently with the gift's charitable purposes.

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