

Higher Education Law Information Memo

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UPMIFA COMES TO NEW YORK

On September 17, 2010, New York became the 47th state to adopt a version of the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). The new law, known as the New York Prudent Management of Institutional Funds Act ("NYPMIFA"), replaces and supplements previous New York law that was based on the Uniform Management of Institutional Funds Act ("UMIFA"), a uniform act that was the predecessor to UPMIFA. NYPMIFA is effective immediately, and its provisions apply to funds in existence as of the effective date, as well as funds created thereafter (with some exceptions discussed below). The enactment of NYPMIFA is a significant development that will require colleges, universities and other charitable organizations to review, and in some respects update, their investment and spending policies and practices.

Historical Background

UMIFA was introduced in 1972 in response to the widely perceived difficulty of applying traditional trust law concepts to institutional fund investment and management by non-profit organizations. Among other things, trust law was viewed as too restrictive in that it imposed limitations on the investment opportunities available to such organizations. UMIFA was designed in part to allow institutions maximum flexibility in obtaining investment returns from endowed gifts, and in particular to enable institutions to invest for maximum total return rather than investing only for current yield. New York adopted UMIFA in 1978.

In 2006, UPMIFA was proposed as a modernization of UMIFA intended to update standards for the investment and management of institutional funds, and to provide greater flexibility in the administration of endowment funds. NYPMIFA is based on UPMIFA but, as described more fully below, includes certain departures from UPMIFA that may be pose challenges for some institutions.

The following is a summary of the significant changes implemented by NYPMIFA. Two reference points must be noted in relation to the summary. First, the NYPMIFA rules described below for the investment, management and expenditure of institutional funds generally apply on a fund-by-fund basis. This is consistent with New York's UMIFA-based prior law, but not necessarily with institutional practices involving the aggregated administration of such funds. Institutions will need to consider how to provide the required individualized focus, particularly in light of the increased documentation required by NYPMIFA.

Second, the NYPMIFA requirements are "default rules" that are generally subject to contrary terms agreed upon by donors and institutions. Thus, practices that are prohibited by NYPMIFA may be validated, and institutional discretion otherwise provided by NYPMIFA may be restricted, by specific gift instrument language. The various provisions described below should be considered subject to the possibility of such "donor overrides."

Standards of Conduct for Managing and Investing Institutional Funds

Formal Investment Policy

NYPMIFA requires that institutions adopt written investment policies setting forth guidelines on investments and delegation of management and investment functions in accordance with the standards of NYPMIFA. Most institutions already maintain such policies as a best practice; however, NYPMIFA now requires them.

Investment Considerations and Practices

Prior New York law, following UMIFA, required institutions to consider specific factors when making decisions regarding the investment of endowment and other institutional funds. NYPMIFA expands the list of factors, and now requires institutions to consider, in addition to any other relevant information regarding the investment of endowment and other institutional funds, the following:

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- 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; and
- an asset's special relationship or special value, if any, to the purposes of the institution.

These considerations are, for the most part, consistent with mainstream practices, but institutions will want to update their investment policies to recite them, and should ensure that board and/or committee minutes are drafted to enable the institution to demonstrate that it fulfilled its obligation to consider the mandatory factors.

NYPMIFA also imposes the following rules with respect to the management and investment of institutional funds, all of which are subject to terms otherwise provided by a gift instrument:

- Management and investment decisions about an individual asset may not be made in isolation, but must instead be made in the context of the fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution.
- The investments of an institutional fund must be diversified unless the institution prudently determines that, because of special circumstances, the purposes of the fund are better served without diversification. A decision not to diversify must be reviewed by the institution as frequently as circumstances require, but at least annually.
- Within a reasonable time after receiving property, an institution must make and carry out decisions concerning the retention or disposition of the property or to rebalance a portfolio, in order to bring the institutional fund into compliance with the purposes, terms, and distribution requirements of the institution as necessary to meet other circumstances of the institution and the requirements of NYPMIFA.
- In managing an institutional fund, an institution may incur only costs that are appropriate and reasonable in relation to the fund's assets, the purposes of the institution and the skills available to the institution.
- A person having special skills or expertise, or selected in reliance on a representation that he/she/it has special skills or expertise, has an affirmative duty to use those skills or expertise in managing and investing institutional funds.

Again, many of these standards are consistent with prudent practices under UMIFA-based prior law, but they are now uniformly required and should be reflected in the mandatory institutional investment policy.

Standards for Delegation of Investment and Management Functions to Outside Professionals

NYPMIFA includes certain provisions impacting the delegation of investment management functions to outside professionals (called "external agents" under the statute). Unless restricted in a gift instrument or otherwise contrary to applicable law, institutions may delegate the management and investment of institutional funds to external agents to the extent prudent under the circumstances. The institution must act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, in:

- selecting, continuing or terminating an external agent, including assessing the agent's independence and the presence of any conflicts of interest the agent has or may have;
- establishing the scope and terms of the delegation, including the payment of compensation, consistent with the purposes of the institution and the institutional fund; and
- monitoring the agent's performance and compliance with the scope and terms of the delegation.

If an institution complies with these duties, it will not be liable for the decisions or actions of the external agent to which management and investment functions were delegated. Again, institutions will want to ensure that their policies reflect these standards, and that minutes are drafted to demonstrate exercise of care in these areas.

NYPMIFA also impacts the terms of arrangements between institutions and external agents. Among other things, the statute specifies the duties of care owed by an external agent to a delegating institution and provides that by accepting delegation of a management or investment function from a New York institution, an external agent submits to the jurisdiction of the New York State court system with respect to proceedings arising from or related to the performance of the delegated function. Strictly speaking, these principles will apply regardless of the terms of contracts with external agents, but institutions may want to insist on language reflecting them in such contracts. In addition, however, in a departure from UPMIFA but consistent with prior New York law, NYPMIFA requires that each such contract include a provision that permits the institution to terminate the contract at any time, without penalty, upon not more than 60 days notice. Based on the prior law, institutions should already have been insisting on the inclusion of such a provision in their contracts with external agents; this practice should continue under NYPMIFA.

Endowment Spending

Relief from the Historic Dollar Value Concept

It is in the area of endowment spending that UPMIFA is designed to provide the greatest flexibility to institutions. By way of background, UMIFA-based prior New York law divided true endowment funds (as opposed to institutionally-designated, or “quasi,” endowments) into three components: historic dollar value, traditional forms of current income (e.g., interest, dividends, rents, profits and royalties), and net appreciation in the value of the fund over historic dollar value. The historic dollar value of a fund consisted of the value of the original gift creating the fund, plus the value of each subsequent donation to the fund at the time it was made, plus the value of each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation was added to the fund.

If consistent with the terms of the gift instrument, an institution could expend traditional forms of income, even if the value of the fund dropped below the historic dollar value. In addition, an institution could appropriate for expenditure certain net appreciation over historic dollar value unless prohibited by the donor in the gift instrument, provided that such appropriation was otherwise prudent under the circumstances. An institution could not, however, spend the historic dollar value of an endowment fund absent donor consent or judicial authorization. Due to the prohibition against expenditure of historic dollar value, the New York State Attorney General took the position that an institution had an affirmative duty to restore to an endowment fund (a) any appropriation that occurred when the value of the fund was already below historic dollar value, and (b) in the case of an appropriation that caused the value of the fund to decrease below historic dollar value, an amount equal to the difference between the historic dollar value and the post-appropriation value of the fund. This resulted in various solutions, including institutions drawing on quasi-endowment or other institutional funds to augment true endowments that had been depleted below historic dollar value via application of a fixed spending rate policy.

UPMIFA eliminates the historic dollar value concept on the theory that the more appropriate analysis involves balancing donors’ desires to both support an institution on a current basis while also maintaining the purchasing power of an endowed fund for the benefit of future generations. Thus, in its original form, UPMIFA permits institutions to expend from endowed funds, even under circumstances in which the expenditure would occur out of historic dollar value, provided that the governing body determines the expenditure to be prudent. NYPMIFA follows UPMIFA in this regard, but includes two restrictions that will significantly limit institutions’ ability to take full advantage of the discretion otherwise provided by UPMIFA.

First, for gift instruments executed on or after the effective date of NYPMIFA, the statute establishes a rebuttable presumption of imprudence where there is an appropriation for expenditure in any year of an amount greater than 7% 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 five years¹ immediately preceding the year in which the appropriation for expenditure is made.² Although the rebuttable presumption of imprudence can be refuted by an institution in the event that an appropriation is questioned, we suspect that institutions will be understandably reluctant to exceed the 7% level in other than dire circumstances.

Perhaps more significantly, NYPMIFA requires, in the case of endowment funds existing prior to its effective date, that an institution contact the donor if the donor is “available” (i.e., if the donor is living, or if not a natural person is in existence and conducting activities, and if he/she/it can be identified and located with reasonable efforts) and give the donor an opportunity to object to the expenditure of historic dollar value the first time such an expenditure is to be made.³ If the donor consents or fails to respond to the notice within 90 days, the institution may appropriate for expenditure out of historic dollar value (if otherwise prudent); if the donor objects, the institution must continue to refrain from doing so. We suspect that many institutions will be reluctant to provide the statutory notice due to donor and/or public relations concerns or, alternatively, may have a difficult time persuading donors not to object to such expenditures. Moreover, because this requirement applies only to funds received prior to the effective date of NYPMIFA from donors who are now “available,” it is likely to create a need for dual-bookkeeping in which the historic dollar value concept is retained for those funds (unless and until the notice procedure is followed) but is eliminated for extremely old funds where the donor is no longer “available” and for new funds received after the effective date. Institutions will need to decide whether this level of effort is justified by the ability to spend without regard to historic dollar value.

1 For an endowment fund in existence for fewer than five years, the fair market value of the endowment fund must be calculated for the period the endowment fund has been in existence.

2 Importantly, this rule does not create a presumption of prudence for an appropriation of an amount less than or equal to 7% of the fair market value of an endowment fund.

3 Institutions are not required to give this notice if the fund consists of gift(s) received as a result of an institutional solicitation without a separate statement by the donor expressing a restriction on the use of the gift(s).

Standards for Appropriation Decisions

NYPMIFA provides that in making determinations as to whether to appropriate or accumulate endowed funds, an institution must consider, if relevant, the following factors:

- 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;
- where appropriate and if circumstances would otherwise warrant, alternatives to the expenditure of the endowment fund, giving due consideration to the effect that such alternatives may have on the institution; and
- the investment policy of the institution.

NYPMIFA requires that for each determination to appropriate or accumulate funds, the institution must keep a contemporaneous record describing the consideration that the institution's governing body gave to each of the factors set forth above. Since the law requires that such decisions be made prudently and in good faith, the relevant minutes or other contemporaneous record should carefully detail the board or committee's considerations so as to demonstrate that these standards were observed.

Release or Modification of Restrictions for "Small and Old" Funds

Consistent with prior law, NYPMIFA permits institutions to obtain relief from donor-imposed restrictions with the donor's written approval or by court order through a proceeding commenced on notice to the Attorney General.⁴ In addition, NYPMIFA establishes a new procedure to allow institutions to unilaterally release or modify restrictions (in whole or in part) and spend endowment funds in circumstances where the size of the fund does not justify the expense and inconvenience associated with a judicial proceeding, and the age of the fund is such that the donor is less likely to be available and/or the stated purpose is more likely to have become obsolete. Specifically, NYPMIFA allows an institution to release or modify donor imposed restrictions if:

- the fund subject to the restriction has a total value of less than \$100,000, and more than 20 years have elapsed since the fund was established;
- the institution determines that a restriction is unlawful, impracticable, impossible to achieve, or wasteful;
- the institution gives notice to the Attorney General and the Attorney General fails to respond within 90 days; and
- the institution uses the property in a manner that reasonably approximates the original intent of the donor.

Notice must also be given to the donor, if he/she/it is "available," unless the fund consists of gift(s) received as a result of an institutional solicitation without a separate statement by the donor expressing a restriction on the use of the gift(s).

Conclusion

The adoption of NYPMIFA presents both opportunities and obligations for New York colleges and universities, and institutions are well advised to review and update their investment and spending policies and practices in light of the new statutory requirements.

Please contact Philip J. Zaccheo, Frank J. Patyi or Paul J. Avery if you have questions or if you wish to discuss any aspect of NYPMIFA in greater detail.

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⁴ Unlike the prior UMIFA-based New York law or UPMIFA in its original form, NYPMIFA also requires that a donor be notified of the proceeding if he/she/it is "available" (as defined above).