# Underwater Endowment Funds: Legal and Accounting Considerations

Many nonprofit organizations, in addition to facing sharply reduced investment portfolios, have recently encountered the unpleasant phenomenon of "underwater" endowment funds—funds that have current market values that have declined below their original values. While organizations have confronted this situation before, a new model law, the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which has already been enacted in a majority of states, provides much greater flexibility than its predecessor, the Uniform Management of Institutional Funds Act (UMIFA), for organizations that wish (or need) to continue to spend from underwater endowment funds. Both statutes define the term "endowment fund" as a fund that is restricted by the donor so that it is not "wholly expendable by the organization on a current basis." Funds designated as an endowment fund by an organization itself (i.e., board-restricted endowment funds) are not endowment funds for purposes of the statutes.

Until recently, most endowments held by charitable organizations were subject to UMIFA, which provides guidelines for spending from endowment funds, as well as for managing and investing charitable funds and releasing or modifying donor restrictions on gifts to charitable organizations. Approved by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1972, UMIFA modernized portfolio management for charitable organizations. UMIFA was eventually adopted in some form by 47 states and the District of Columbia and is still in effect in many states.

In 2006, NCCUSL approved revisions to UMIFA. The revised statute, UPMIFA, has been enacted in 28 states plus the District of Columbia. UPMIFA has been introduced in the legislatures of several other states. Many organizations are interested in encouraging rapid passage of UPMIFA because the statute permits expenditures from underwater endowment funds. Additional nationwide information about the enactment status of UPMIFA is available at www.upmifa.org.

In addition to providing greater flexibility for endowment spending, UPMIFA includes several other important changes from UMIFA. This alert summarizes certain legal considerations for nonprofit organizations that would like to continue to spend from underwater endowment funds. It also provides a summary of the key provisions of UPMIFA and a brief explanation of FSP FAS 117-1, a new FASB statement providing financial statement reporting rules for endowments affected by UPMIFA and additional financial statement disclosures for all organizations.

## Spending from Underwater Endowment Funds in UPMIFA States

Most importantly for organizations located in states that have enacted UPMIFA, the new statute liberalizes UMIFA's endowment spending rules applicable to underwater endowment funds. Under UMIFA, a charity can spend appreciation from an endowment fund over the fund's "historic dollar value"—the aggregate value of all contributions to an endowment fund at the time they were made—to the extent the charity deems prudent. In other words, the charity may treat some of the endowment appreciation as income that may be distributed currently. But, under UMIFA, a charity with an underwater endowment fund may only distribute current income (e.g., dividends and interest) from the fund; it cannot spend below the fund's historic dollar value. The historic dollar value limitation has proven to be administratively and economically

burdensome for organizations, particularly in situations where a new endowment is created shortly before or during a downturn in the economy and then falls below historic dollar value because of investment performance.

Under UPMIFA, charities are no longer restricted by historic dollar value. Instead, a charity can spend the amount it deems prudent after considering the donor's intent, the purposes of the fund, and several economic factors listed in the statute. In general, if a donor restricts an endowment fund's distributions to "income," a prudent spending rule that exceeds ordinary income—such as dividends and interest—may be adopted. But if the donor specifies the types of income that may be distributed, that specification will control.

Of the 28 states plus the District of Columbia that have enacted UPMIFA to date, nine have opted to include an optional provision that creates a rebuttable presumption of imprudence for spending more than a certain percentage (7 percent in most states) of the value of an endowment fund in one year (calculated by valuing the fund at least quarterly and averaging values over three years). The optional provision does not create a safe harbor presumption of prudence for spending less than the percentage cap. The percentage cap is viewed by many as arbitrary and unnecessary. New Hampshire and Texas have enacted UPMIFA with another optional provision requiring a charity with endowed funds of less than $2,000,000 to give 60 days notice to the attorney general if it plans to spend an amount that would cause the value of the charity's endowment funds to drop below the aggregate historic dollar value of all the charity's funds.

Despite the welcome flexibility provided by UPMIFA, boards will still need to be careful when deciding to spend from an underwater fund because there are, as yet, few rules or even conventions as to how boards are expected to make this decision. As a general matter, we recommend that organizations in states that have adopted UPMIFA consider taking the following steps before spending from underwater endowment funds:

- Organizations should review their gift agreements for any provisions that would override the UPMIFA rule permitting expenditures of more than ordinary income from underwater funds. For example, a fund formed by a gift instrument that provides that the organization can spend only 4 percent per year from the fund will be governed by that restriction and need not be subjected to the prudent spending analysis required by UPMIFA. However, a fund formed by a gift instrument that states simply that the organization should "hold the fund as an endowment" will be entitled to rely on UPMIFA's expenditure provisions.
- Organizations may wish to revise their endowment spending policies to refer to the prudent expenditure factors listed in their state's version of UPMIFA.
- Organizations in states that have adopted a percentage cap on endowment fund spending (typically 7 percent) should review their endowment spending policies to ensure that the policies are consistent with the percentage cap. Organizations in such states should also confirm that the market values of endowment funds are determined at least quarterly and may wish to amend their spending policies to require such valuations.
- When making the decision to spend funds from an underwater endowment fund, an organization should document in minutes of the meeting of the governing board or relevant committee its consideration of the factors listed in its state's UPMIFA statute.

## Spending from Underwater Endowment Funds in UMIFA States

As explained above, organizations still subject to UMIFA are limited to spending only current income from underwater endowments. Organizations in UMIFA states also should take care to understand any particular state requirements regarding expenditures from underwater funds. For example, the New York Attorney General has taken the position that an organization has an affirmative duty to restore the historic dollar value of a fund that becomes underwater as a result of the organization's spending rate policy rather than as a result of market depreciation. Despite the limitations imposed by UMIFA, there are at least two steps that cash-strapped organizations can take when evaluating expenditure options:

- Organizations can review their records to make sure that all funds treated as permanently restricted endowment funds are in fact subject to donor restrictions that do not permit the expenditure of principal. For example, it is not necessary to track and preserve historic dollar value for funds set aside as an endowment fund by the organization's board. Similarly, some funds treated as permanently restricted may in fact be subject to gift instruments that do not impose legally binding requirements that the funds be maintained as a permanently restricted endowment funds.
- Organizations may want to consider contacting the donor who contributed a fund that is now underwater to request that the donor grant (in writing) permission for the organization to apply its spending rate policy to the fund even if doing so will cause the fund to fall below historic dollar value.

## Other Important UPMIFA Provisions

While the endowment spending flexibility permitted by UPMIFA may be the most important provision of the statute in the current economic climate, there are other provisions in the statute of which organizations should be aware.

**Release or Modification of Donor Restrictions**

UPMIFA provides a new procedure that permits organizations to change or release a restriction imposed by a donor on certain funds. In the model statute, the provision can be used if a fund is more than 20 years old and has a value of less than $25,000. However, states may adjust the age and value aspects of the provision. For example, California's version of UPMIFA permits organizations to release restrictions on a fund that has a value of less than $100,000. The provision requires that the organization notify the state's attorney general before modifying the restriction—the model statute suggests a 60-day notification period—to give the attorney general time to object to the proposed modification. The organization is required to use the property in a manner consistent with the donor's intent.

UPMIFA, like UMIFA, permits a donor to release or modify a restriction on a gift. UPMIFA also retains a provision from UMIFA permitting a charity to seek modification of a restriction on a gift from a court (with notice to the attorney general) in situations where the charity is unable to obtain the donor's consent. The UPMIFA requirements for modification of a restriction by a court are more detailed than UMIFA's, however, and explicitly require that the modified use of the funds be consistent with the charitable purposes expressed in the gift instrument.

**Investment Standards**

UPMIFA updates UMIFA's investment standards by incorporating elements of current trust and corporate law on the theory that the standards for management and investment of charitable funds should be the same for charitable trusts and nonprofit corporations. UPMIFA requires that fiduciaries act "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." The statute refines this general standard by identifying the following factors that should guide fiduciaries in making investment decisions:

- General economic conditions;
- Possible effects of inflation or deflation;
- Expected tax consequences of investment decisions;
- The role of each investment in the whole portfolio;
- The expected total return from income and growth of investments;
- Other resources of the organization;
- The needs of the organization and the fund to make distributions and to preserve capital; and
- An asset's special relationship or special value, if any, to the charitable purposes of the organization.

UPMIFA also provides that in managing and investing a charitable fund an organization "may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the organization, and the skills available to the organization. . . " Endowment management costs were not addressed in UMIFA.

**Application of UPMIFA**

UPMIFA applies to nonprofit corporations, unincorporated associations, and other charitable entities. UPMIFA also applies to charitable trusts, but only trusts that have a charity as a trustee. Thus, many private foundations and some community trusts are not subject to UPMIFA. In addition, charitable remainder trusts are not covered by UPMIFA until non-charitable interests have terminated.

UPMIFA applies retroactively to all endowment funds and other funds held by organizations for charitable purposes.

## New Accounting Rules for Endowments

On August 6, 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position FAS No. 117-1, "Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Organizational Funds Act, and Enhanced Disclosures for All Endowment Funds" (the "FSP"). FASB determined that the rapid enactment of UPMIFA by many states and UPMIFA's elimination of the historic dollar value threshold required new guidelines regarding financial statement reporting of donor-restricted endowment funds. FASB also concluded that additional disclosures about endowments were needed for all organizations in light of the current trend toward increased scrutiny of endowments.

Most of the FSP's provisions apply only to organizations in states that have adopted UPMIFA, and several provisions affect the reporting of underwater endowments for such organizations. However, all organizations with endowment funds, which FASB defines broadly to include quasi-endowment as well as donor-restricted endowment funds, are subject to the new disclosure requirements.

For organizations in states that have enacted UPMIFA, the main provisions of the FSP are as follows:

- The FSP requires organizations to classify a portion of a donor-restricted endowment fund as permanently restricted net assets. The permanently restricted amount is: (1) the amount that must be permanently retained in accordance with explicit donor stipulations, or (2) in the absence of such stipulations, the amount that the organization's governing board determines must be permanently retained consistent with relevant law. An appendix to the FSP indicates that FASB assumes organizations generally will classify the amount of a fund's historic dollar value as permanently restricted net assets or possibly historic dollar value adjusted for inflation. This portion of the FSP has been criticized as inconsistent with UPMIFA, which explicitly eliminated the concept of historic dollar value.
- The FSP retains the controversial requirement of FASB Statement 124 (November 1995) providing that the portion of a donor-restricted endowment fund that is classified as permanently restricted net assets is not reduced by losses on investments of the fund (except to the extent required by the donor) or by an organization's appropriations from the fund. Under Statement 124, losses and appropriations from the permanently restricted portion of a donor-restricted endowment fund are charged first to "temporarily restricted" net assets and then to unrestricted net assets. Thus, despite the fact that there is no legal requirement to restore underwater funds to historic dollar value in UPMIFA states, the FSP requires organizations to reduce temporarily restricted net assets (if the fund has accumulated unspent appreciation classified as temporarily restricted) or unrestricted net assets (if the fund has no accumulated appreciation or losses have exceeded the amount of appreciation). Because UPMIFA does not require

an organization to replenish a fund to its historic dollar value, or even to reduce distributions from an underwater fund to dividend and interest income, a Board will want to be careful about making a determination that a portion of a fund is permanently restricted.

- Any portion of a donor-restricted endowment fund (including appreciation) that is not classified as permanently restricted should be classified as temporarily restricted until appropriated for expenditure.
- Organizations must identify the portion of an endowment fund that is not permanently restricted and that has not been previously appropriated for expenditure (e.g., unappropriated appreciation on the fund). Any such amounts that were previously classified as unrestricted net assets must be reclassified as temporarily restricted net assets until they have been appropriated for expenditure.

The FSP also requires that all organizations, whether or not subject to UPMIFA, make new disclosures regarding their endowments, including:

1. A description of the governing board's interpretation of the laws underlying the organization's net asset classification of donor-restricted endowment funds.
2. A description of the organization's endowment spending policy.
3. A description of the organization's investment policy.
4. The composition of the organization's endowment by net asset class.

The provisions of FSP 117-1 are effective for fiscal years ending after December 15, 2008.

If you have any questions about underwater endowments, UPMIFA, UMIFA, or FSP FAS No. 117-1, please contact your usual Ropes & Gray attorney or any of the attorneys listed below.

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| Peter C. Erichsen | A.L. (Lorry) Spitzer | Morey O. Ward |
| Christopher A. Klem | Carolyn M. Osteen | Kendi E. Ozmon |

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