Managing Nonprofit Endowments and Institutional Funds: A Brief Overview of the Uniform Prudent Management of Institutional Funds Act

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ABSTRACT

The article explores the key features of the Uniform Prudent Management of Institutional Funds Act, along with the Uniform Law Commission's comments and explanations, to provide an overview of the national landscape of endowment and institutional fund management.

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I. INTRODUCTION

When a nonprofit organization establishes an endowment or institutional fund, the organization's management and investment obligations are governed by applicable state law. While endowment laws vary among states, they share many common features thanks to the Uniform Prudent Management of Institutional Funds Act ("Model Law" or "UPMIFA").

Like many other model laws that have been widely adopted across the country, UPMIFA was drafted by the Uniform Law Commission. Founded in 1892, the Commission consists of attorneys, judges, legislators, and law professors who are appointed by state governments "to research, draft and promote enactment of uniform state laws in areas of state law where uniformity is desirable and practical."[1]

The Uniform Law Commission passed UPMIFA in 2006.[2] Since then, the Model Law has been adopted in one form or another by most states.[3] The Model Law thus provides a useful overview of the national landscape of endowment and institutional fund governance. However, each state's lawmakers decide whether to adopt UPMIFA in whole or in part and whether to modify its language.[4] The Model Law also contains optional provisions, which some states adopt while others do not.[5] This makes it important for nonprofits to base their endowment and institutional fund policies on their state's law, rather than the Model Law.

II. CORE PRINCIPLES AND KEY DEFINITIONS

Under the Model Law, endowment and institutional fund management is based on two core principles: first, assets should be invested prudently in diversified investments that seek growth and income; and second, once assets appreciate, the appreciation can be prudently spent for the endowment's purposes.[6] In other words, organizations may prudently spend the income generated by their investments and, when the principal appreciates, organizations may also

1. *About Us*, UNIF. L. COMM'N, https://perma.cc/NJ9S-734F (last visited Jan. 5. 2024).
2. *Prudent Management of Institutional Funds Act: Enactment History*, UNIF. L. COMM'N, https://perma.cc/57W8-XAHH (last visited Jan. 5, 2024)
3. *Id.*
4. *See generally* UNIF. PRUDENT MGMT. OF INST. FUNDS ACT, prefatory note (UNIF. L. COMM'N 2006).
5. *Id.*
6. *Prudent Management of Institutional Funds Act: Summary*, UNIF. L. COMM'N, https://perma.cc/CM9P-7TFL (last visited Mar. 12, 2024) [hereinafter *Summary*, UNIF. L. COMM'N].

prudently spend the appreciation.[7] As the Uniform Law Commission explains: "These two principles have been the twin lodestars of asset management for endowments since [1972, when the original version of UPMIFA] became the law of the land in nearly all US jurisdictions."[8]

A. Definition of Endowment Fund

The Model Law defines an "endowment fund" as "an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis."[9] In plain English, this means that an endowment results from a restricted donation that is conditioned on the organization investing the principal and benefiting from its income, rather than spending the principal for immediate needs.[10] By contrast, if a donor makes a gift for a specific upcoming project, such as this year's building renovations, then the gift is not an endowment. Likewise, if a donor makes an unrestricted gift, then the organization can spend it immediately. In both cases, the donor expresses no intent of preserving principal.

B. Definition of Institutional Fund (and the Distinction between True Endowments and Quasi Endowments)

Under the Model Law, the definition of "endowment fund" specifically excludes "assets that an institution designates as an endowment fund for its own use."[11] A true endowment is established through a restricted gift: a donor may say, "the principal must be maintained and only the income can be spent," or more simply, "this gift is for your endowment," which has the same effect.[12] As discussed in more detail below, UPMIFA imposes various protections on the principal of endowment funds.

On the other hand, when a nonprofit designates surplus revenue as investment assets, the resulting "institutional fund" (often called a "quasi endowment" or "board-designated endowment") is not subject to the Model Law's protections of investment principal. While an "endowment fund" entails a principal-protected gift, the Model Law defines "institutional fund" more broadly as any "fund held by an institution for charitable purposes," excluding "program-related assets."[13]

7. *Id.*
8. *Id.*
9. UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 2(2) (UNIF. L. COMM'N 2006).
10. *Id.*
11. *Id.*
12. *Id.* § 2(3) cmt.
13. *Id.* § 2(5) (the definition also excludes certain other categories of assets).

Let us take the example of a nonprofit that ended a particular fiscal year with significant surplus revenue that is not subject to any donor restrictions. The organization may plan to spend those funds on program enhancements, hiring more staff, and increasing organizational capacity – in which case, the funds would be considered "program-related assets" and thus carved out of the definition of "institutional fund." But if, after such planned spending, the organization has additional funds remaining that the board decides to invest, then that investment becomes an institutional fund under the Model Law.

The institutional fund is unrestricted, in the sense that no donor has limited how it can be used. Unlike the principal of an endowment fund, the principal of an institutional fund may be spent as needed by the organization.[14] The comments to the Model Law explain the distinction between endowment funds and institutional funds as follows:

An endowment fund is an institutional fund or a part of an institutional fund that is not wholly expendable by the institution on a current basis. A restriction that makes a fund an endowment fund arises from the terms of a gift instrument.

Board-designated funds are institutional funds but not endowment funds. The rules on expenditures and modification of restrictions in [the Model Law] do not apply to restrictions that an institution places on an otherwise unrestricted fund that the institution holds for its own benefit. The institution may be able to change these restrictions itself, subject to internal rules and to the fiduciary duties that apply to those that manage the institution.[15]

In other words, as to institutional funds, the board has the flexibility to use both the principal and income to achieve the organization's charitable purposes. By contrast, when a donor gives a restricted gift that goes into a true endowment, the organization must protect the principal.[16]

III. THE STANDARD OF CONDUCT FOR MANAGING AND INVESTING INSTITUTIONAL FUNDS

Section 3 of the Model Law imposes a number of obligations on most decision-makers who are involved in managing and investing in an institutional fund. As the comments explain: "The duties imposed by this section apply to those who govern an institution, including directors and trustees, and to those to whom the directors or managers delegate

14. *Id.* § 2(2) cmt.
15. *Id.*
16. As already noted, donor funds that are intended for program-related purposes, along with unrestricted gifts that an organization plans to use for its operating needs, are neither endowment nor institutional funds and are not subject to the constraints of the Model Law.

responsibility for investment and management of institutional funds," including officers, employees, and third-party asset managers.[17]

First and foremost, UPMIFA requires that decision-makers give "primary consideration" to the donor intent expressed in the gift instrument,[18] followed by consideration of the charitable purposes of the organization and the specific objectives of the institutional fund.[19] All management and investment decisions must be made in light of these considerations.

The Model Law also requires decision-makers to act in accordance with a number of fiduciary duties: (1) they must exercise the duty of care and act with good faith when performing investment and management activities; (2) they have a duty to minimize investment costs and authorize only those costs that are appropriate and reasonable; (3) they must investigate the information used when making investment decisions and managing the fund; and (4) they must act in accordance with the duty of loyalty, which requires managing and investing the assets solely in the best interests of the organization.[20]

When managing and investing an institutional fund, decision-makers should consider the following factors: general economic conditions; effects of inflation and deflation; tax consequences, if any, of investment decisions; the role of each investment in the overall portfolio; the expected total return from income and appreciation of the assets; other resources of the organization; the needs of the organization and fund to make distributions and preserve capital; and an asset's special relationship or value, if any, to the charitable purposes of the organization.[21]

The Model Law emphasizes that decisions regarding individual assets cannot be made in isolation; rather, they should be made in light of the entire portfolio and overall investment strategy, which should have risk and return objectives that are suited to the fund and organization.[22] The Model Law allows fund assets to be invested in "any kind of property or type of investment," subject to donor restrictions (such as not investing in tobacco products, to use an example from the comments).[23] Assets must also be diversified, unless special circumstances dictate otherwise.[24] And new assets must be reviewed within a reasonable time

17. *Id.* § 3 cmt. Purpose and Scope of Revisions.
18. *Id.* prefatory note.
19. *Id.* § 3(a)-(e).
20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.*

after they are donated to ensure they conform to the investment strategy and objectives of the fund.[25]

These are the primary duties and standards of conduct that apply to managing and investing institutional funds. Note that these duties and standards apply to institutional funds generally, rather than endowment funds specifically. Indeed, this particular part of the Model Law (Section 3) does not include the word "endowment" at all, but uses only the broader term "institutional fund." The above requirements thus apply to *most people* who invest and manage funds for a nonprofit, and *most funds* that are invested and managed by a nonprofit.

IV. EXPENDITURE AND ACCUMULATION OF ENDOWMENT FUNDS

After setting forth the standards and duties that apply to institutional funds generally, the Model Law turns to specific requirements regarding spending and accumulating endowment assets. Section 4 of the Model Law begins as follows: "Subject to the intent of a donor expressed in the 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."[26]

A. The Seven Factor Prudence Test

The Model Law sets forth seven factors to consider when making accumulation and spending decisions, all of which are subject to the duty to act in good faith and exercise the care that a prudent person would exercise in similar circumstances.[27] These factors are as follows:

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.[28]

25. *Id.*
26. *Id.* § 4(a).
27. *Id.*
28. *Id.* § 4.

Note that this "Seven Factor Prudence Test" is subject to donor restrictions.[29] If, for example, a donor requires the organization to "preserve the principal intact," then only the income from the gift can be spent; the principal cannot be touched.[30] Moreover, the Model Law imposes specific rules of construction on terms like "income" and "endowment." As the comments explain: "The assumption . . . is that a donor who uses one of these terms intends to create a fund that will generate sufficient gains to be able to make ongoing distributions from the fund while at the same time preserving the purchasing power of the fund."[31] Thus, as time goes by, some appreciated value of the principal must be preserved to maintain the spending power of the original gift.

B. The Optional Seven Percent Rule

When drafting the Model Law, one of the Uniform Law Commission's primary concerns was preventing imprudent and excessive spending of endowment assets. The drafters were satisfied with the Seven Factor Prudence Test, but also recognized that some states may prefer more concrete protections. Thus, as the comments explain:

> If a state does not want to rely solely on the rule of prudence provided in UPMIFA, the state may adopt a provision that creates a rebuttable presumption of imprudence if an institution spends more than seven percent of the fair market value of a fund, calculated in an averaging formula over three years.[32]

This "Seven Percent Rule" is intended to prevent spending down an endowment too quickly.[33] However, the drafters explain that spending seven percent of an endowment in a particular year may itself be imprudent, while spending above seven percent in a different year may be prudent and reasonable. The decision of how much of the endowment to spend must be based on thoughtful consideration of the Seven Factor Prudence Test, even if a particular state adopts the Seven Percent Rule.[34] The comments explain:

A variety of considerations cut against including a presumption of imprudence in the statute. A fixed percentage in the statute might be perceived as a safe harbor that could lead institutions to spend more than is prudent. Although the provision should not be read to imply that spending below seven percent will be considered prudent, some charities

29. *Id.* § 4(c) cmt.
30. *Id.*
31. *Id.*
32. *Summary*, UNIF. L. COMM'N, *supra* note 6.
33. *Id.*
34. *Id.* prefatory note on "Endowment Spending".

might interpret the statute in that way. Decision makers might be pressured to spend up to the percentage, and in doing so spend more than is prudent, without adequate review of the prudence factors [the Seven Factor Prudence Test] as required . . . .

Perhaps the biggest problem with including a presumption in the statute is the difficulty of picking a number that will be appropriate in view of the range of institutions and charitable purposes and the fact that economic conditions will change over time. Under recent economic conditions [the Model Law was passed by the UCL in 2006], a spending rate of seven percent is too high for most funds, but in a period of high inflation, seven percent might be too low. In making a prudent decision regarding how much to spend from an endowment fund, each institution must consider a variety of factors, including the particular purposes of the fund, the wishes of the donors, changing economic factors, and whether the fund will receive future donations.

Whether or not a statute includes the presumption, institutions must remember that prudence controls decision making. Each institution must make decisions on expenditures based on the circumstances of the particular charity.[35]

To give some historical context, the old version of UPMIFA included a rule that prohibited spending an endowment fund below its historic dollar value.[36] The "Historic Dollar Value Rule" suffers from a number of issues, including the fact that, after a fund has been in existence for many years, historic dollar value no longer represents the original purchasing power of the gift.[37] As already explained, when donors use language such as "income" and "endowment," the Model Law assumes an intent to preserve the purchasing power of the gift. While the Model Law does not require that a specific amount be set aside as principal, the law "assumes that the charity will act to preserve 'principal' (*i.e.* to maintain the purchasing power of the amounts contributed to the fund) while spending 'income' (*i.e.* making a distribution each year that represents a reasonable spending rate, given investment performance and general economic conditions)."[38]

The drafters recommend that organizations establish a spending policy that is responsive to short-term fluctuations in the value of the fund while maintaining "appropriate levels of expenditures in times of economic downturn or economic strength."[39] In some years, it will be more prudent to accumulate endowment assets than spend them, while in

35. *Id.* § 4(d) cmt..
36. *Summary*, UNIF. L. COMM'N, *supra* note 6.
37. *Id.* prefatory note on "Endowment Spending".
38. *Id.*
39. *Id.*

other years "an institution may appropriately make expenditures even if a fund has not generated investment return that year."[40] As a decision-making guide, the Model law "emphasizes the endowment aspect of the fund, rather than the overall purposes or needs of the institution."[41]

Note that UPMIFA gives significant deference to donor restrictions. If a donor directs an organization to spend an endowment fund over some number of years, then that is what the organization should do. As explained in the comments:

The term 'endowment fund' includes funds that may last in perpetuity but also funds that are created to last for a fixed term of years or until the institution achieves a specified objective. [Organizations must] consider the intended duration of the fund in making determinations about spending. For example, if a donor directs that a fund be spent over 20 years, . . . [the] institution would amortize the fund over 20 years rather than try to maintain the fund in perpetuity. For an endowment fund of limited duration, spending at a rate higher than rates typically used for endowment spending will be both necessary and prudent.[42]

C. Variations Among States

As already mentioned, whether a state adopts the Model Law, and the extent to which a state adopts the Model Law, is wholly within the discretion of that state's lawmakers. This means that some states may presume imprudence if a charity spends more than seven percent of its endowment in one year, while other states may still rely on the old Historic Dollar Value Rule (from the previous version of UPMIFA).

Moreover, while the Model Law has mostly eliminated the Historic Dollar Value Rule, the comments provide states with an optional version of the rule as to small endowments (those with a value of $2,000,000 or less), based on a concern that small endowments may be invested and managed by unsophisticated investors who are more likely to make imprudent decisions.[43] In a state that chooses to adopt the optional rule, if a small endowment "decides to appropriate an amount that would cause the value of its endowment funds to drop below the aggregate historic dollar value for all of its endowment funds, then the institution will have to notify the attorney general before proceeding with the expenditure."[44]

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40. *Id.*
41. *Id.*
42. *Id.* § 4 cmt. on "Distinguishing Legal and Accounting Standards".
43. *Id.* § 4 cmt. on "Institutions with Limited Investment and Spending Experience".
44. *Id.*

These types of variations among states are among the reasons that organizations should carefully review their state's endowment laws when drafting and reviewing endowment policies.

V. DELEGATION OF MANAGEMENT AND INVESTING

The Model Law allows organizational decision-makers to delegate fund management and investing to third party managers. In choosing a manager, decision-makers must act in good faith and use reasonable skill, care, and caution while ensuring that the manager's fees are reasonable. They must also define the scope of the investment manager's work in light of the purposes of the institutional fund, and they must periodically review the manager's actions to monitor performance and ensure compliance with the scope of delegation.[45] Notably, the Model Law only allows *management* and *investment* functions to be delegated: "decision makers cannot delegate the authority to make decisions concerning expenditures . . . ."[46]

VI. RELEASE AND MODIFICATION OF DONOR RESTRICTIONS

The Model Law gives significant deference to donor restrictions but also recognizes that restrictions may become impracticable, wasteful, or an impediment to fund management over time. When this happens, a donor may simply consent to release the restriction – assuming the donor is alive and has capacity to do so.

When this is not possible, the Model Law provides a mechanism for organizations to seek court approval to modify restrictions in accordance with the donor's probable intent.[47] The Model Law also allows organizations to modify restrictions on small and old funds without going to court. If a fund contains less $25,000 and is more than 20 years old, then the organization may notify the attorney general of its planned modification, and if there is no objection within 60 days, modify the restriction in light of the charitable purposes expressed when the original gift was made.[48]

45. *Id.* § 5.
46. *Id.* § 5 cmt.
47. *Id.* § 6; *Summary*, UNIF. L. COMM'N, *supra* note 6 (the organization must notify the state's attorney general, who may choose to participate in the proceeding).
48. UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 6.