



Nonprofit Organizations Alert

Developments in nonprofit law

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Autumn in New York—dealing with falling endowment investment returns

By Michael J. Cooney

These are difficult times, and the last thing New York's charities need is complicated rules on how they can access their endowed long-term investment assets. Yet, that is precisely what charities in our state are facing. And, while there is plenty of blame to go around for the poor performance of the financial markets, the complexity of New York's rules on the investment and expenditure of endowment funds is the product of decades of indifference from our state lawmakers and regulators.

So what?

Not all charitable funds are created equally. An endowment restriction prohibits a fund from being wholly expended on a current basis. Normally, an endowment restriction requires that the principal be maintained intact and only income used currently. The mere use of the term "endowment" in a gift instrument is sufficient to bring to bear all the relevant provisions of the law. It is an amazingly useful device for donors and charitable recipients.

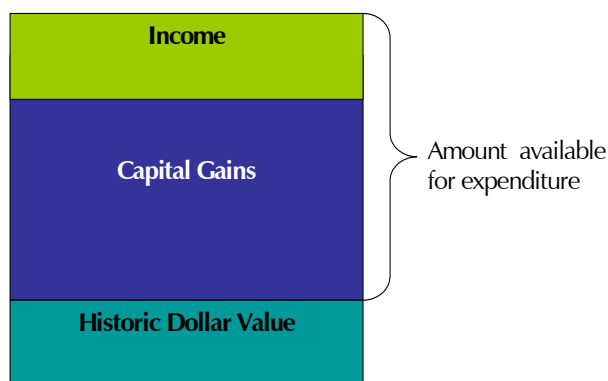
To constitute a true endowment under New York, the restriction must arise from a clearly expressed donor limitation. "Board-restricted endowment" or "quasi-endowment" is not really legally restricted at all. And New York law is clear that, whether under Not-for-Profit Corporation Law (N-PCL) Section 513; Estates, Powers, and Trusts Law Section 8-1.1; or New York's judge-made common law, any gift received with donor restrictions must be applied in accordance with those restrictions. To do otherwise is a breach of fiduciary duty of the charity's governing board.

Here's that rainy day

The essence of an endowment fund is that it acts as an enforced savings device—a perpetual rainy-day fund. Historically, however, corporate fiduciaries were tied to antiquated trust concepts of income, and so forced to choose between higher current yields with limited future growth potential versus greater total return over the long term with limited current income for operations.

That changed in 1978, when New York adopted portions of the Uniform Management of Institutional Funds Act (UMIFA). The new rule is easy to express, but a bit complicated to apply. It permits the governing board (absent an explicit donor restriction to the contrary) to appropriate for expenditure as much as the board deems prudent of the net appreciation realized (with respect to all assets) and unrealized (with respect only to readily marketable assets) in the fair market value of an endowment fund over its historic dollar value.

So, any endowment fund can be thought of in a number of layers. “Historic dollar value” or “HDV” is defined by N-PCL Section 102(a)(16) as the aggregate fair value in dollars of: (i) an endowment fund at the time it became an endowment fund; (ii) each subsequent donation to the fund at the time it is made; and (iii) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the fund. The determination of HDV made in good faith by the charity’s governing board is conclusive. HDV under New York law is held inviolate.



To the extent, then, that an endowment fund has appreciated in value above its HDV, the charity has the opportunity to expend that appreciation if it is prudent to do so. The expenditure policy needs to be consistent with the investment policy. For many charities, that meant adopting a “total return” approach that appropriated for expenditure a set percentage of the endowment fund, based on a rolling 12- or 20-quarter average. Expendable income was, in effect, redefined under this mechanism to include some portion of capital gains.

New York, New York

Yet, when UMIFA was adopted in New York, it was not without some modifications. Unlike other states, New York distinguished between realized gains on “all investments” and unrealized gains for “readily marketable assets.” So, as modern portfolio theory moved to hedge funds and other highly illiquid alternative investments to lessen risk and improve return, New York carved out those assets out of the total-return approach.

Further, while charities will commonly pool and co-invest their endowment funds, the NYS Attorney General has also made it clear that endowment funds may not be aggregated for purposes of determining net appreciation. Thus, expenditures are made

on a fund-by-fund basis, each with its own HDV and net appreciation (realized and unrealized), all subject to a single spending rule.

Bewitched

But what, then, of a relatively recent endowment, invested like other endowment funds with the expectation of bountiful total returns over a perpetual life, but suddenly buffeted by market forces that drive the market value of the fund to below HDV? This is the classic “underwater” endowment. The cushioning effect of a rolling quarterly distribution calculation is of little use when there is no appreciation (realized nor unrealized) to which to apply a spending formula.

The issue was addressed by the Attorney General Charities Bureau earlier in the decade during the last market downturn. That guidance is available at:

<http://www.oag.state.ny.us/bureaus/charities/pdfs/endowment.pdf>

Essentially, it forces the charity to pull these newer endowments out of the total-return spending formula for fear of spending below HDV, or to seek donor consent to do so. Accounting and investment challenges abound.

This issue was raised six years ago, but nothing was done to address it.

What’s new?

Enter the Uniform Prudent Management of Institutional Funds Act (UPMIFA), adopted currently in 25 states and the District of Columbia. New York has not even introduced legislation to consider the uniform statute, although representatives from the Attorney General Charities Bureau were active in its initial consideration.

UPMIFA does away with the concept of HDV, relying instead on more clearly defined standards of business prudence for investment and expenditure of endowment funds. The effect is to free the governing board from technical accounting and investment management concerns over underwater endowments, providing the fiduciary authority one might assume the donors felt comfortable in letting the board exercise when the gift or bequest was made.

UPMIFA makes other changes, modernizing a uniform act first created in 1972, based on the 35 years of learning since then. New York, however, has done nothing to consider adopting these changes. The markets, charitable institutions, donors, and even the accounting community continue to evolve in their thinking about these issues with new guidance and approaches, but New York state’s charities remain at a distinct disadvantage in their ability to attract, manage, and expend the most basic of long-term funds—the endowment.

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