LANCASTER POLLARD

The Nonprofit Minute

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About the Firm

Lancaster Pollard Investment Advisory Group, an SEC-registered investment advisor, helps nonprofit organizations create the financial means to last the life of their missions by managing *total* financial risk rather than just investment-associated risk. Lancaster Pollard Investment Advisory Group shares common ownership with Lancaster Pollard, a leading provider of investment banking and mortgage banking services for the senior living, health care, affordable housing and private education sectors.

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Up to Speed with UPMIFA

The flexibility to prudently manage an investment portfolio and its spending policy is crucial when the markets are down, and nonprofits in states that have adopted the Uniform Prudent Management of Institutional Funds Act into law may find it easier to weather the current volatility.

UPMIFA updates policies set in place in 1972 by the Uniform Management of Institutional Funds Act (UMIFA), which 47 states adopted into law. The new version introduces investment principles that incorporate modern portfolio theory. It gives organizations the direction to better manage endowment assets, updates spending rules to address market volatility and fluctuations in asset balances, and allows organizations with restrictions on assets or charitable purposes to modify or release them according to the doctrines of "cy pres" and "equitable deviation." UPMIFA was approved and recommended for enactment in 2006 by the National Conference of Commissioners on Uniform State Laws. So far, it has been adopted into law by 26 states and the District of Columbia, and others have UPMIFA legislation pending. The major changes involve investment management, endowment spending, and the release or modification of restrictions.

Investment Management

1972's UMIFA formalized the process by which endowment funds were to be managed, allowing organizations to invest in any kind of asset, to pool accounts, to retain property, and to hire professional investment management. But some of these guidelines were vague or open to interpretation. UPMIFA clarifies the standards of conduct in managing institutional funds and strengthens the rules governing management and investment decisions. In essence, it directs those responsible for asset management to use a holistic approach in making decisions and consider the fund's risk versus return objectives. Further, it emphasizes diversification and asset allocation, which follow the ideas perpetuated by modern portfolio theory.

Nonprofits are now obligated to consider the following factors from the act, if relevant:

- General economic conditions
- Effects of inflation or deflation
- Tax consequences
- How each investment fits within

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the total portfolio

- Portfolio's expected total return
- Other resources available to the institution
- Institutional needs and the relationship between distributions and capital preservation
- An asset's special relationship or value, if any, to the charitable purposes of the institution.

Most nonprofit boards today would see these considerations as standard good practice; UPMIFA codifies them. These imposed duties apply to directors, trustees, investment managers, officers and agents who invest institutional funds. Volunteers will be subject to the same standards, but may be less culpable under state and federal laws.

Endowment Spending

Nonprofits' endowment spending policies are much more adaptable than they were before 1972, when spending was generally limited to interest from bonds and income from dividends. UMIFA let organizations appropriate realized or unrealized capital gains, as well, but it did not allow for spending that would subject the fund to fall below the original amount of the donor's gift, or its historic dollar value.

> Organizations can check their state's UPMIFA status and compare the new Act's language with older regulations at www.upmifa.org.

UPMIFA allows for appropriation of the endowment as much as the institution "deems prudent for the uses, benefits, purpose and duration for which the fund was established," subject to the evaluation of several specific factors including general economic conditions and the fund's purpose.

To provide more direction, UPMIFA lets the states consider using language that creates a "rebuttable presumption of imprudence" for organizations that spend more than 7 percent of the value of the assets annually, where the value is calculated as the average asset balance over the previous 12 quarters. The rule does not imply that spending under 7 percent is automatically acceptable; any spending must be prudent under the factors listed in UPMIFA, and spending above 7 percent may be deemed prudent if the organization can provide a strong argument.

Release or Modification of Restrictions

Under UMIFA, assets that were restricted either had to remain restricted, or the restriction had to be lifted (released) completely; restrictions could not be modified. UPMIFA makes it possible to modify or release restricted assets. UPMIFA clarifies how those modified or restricted assets can be used by expressly including the trust law doctrines of "cy pres" and "equitable deviation." These doctrines say, essentially, that if a donation cannot be used the way it was originally intended, then it must be used in a way that is close to the original intent. The donor can consent to the release or modification of a restriction or, if the donor is not available and the restriction has become impractical, the organization may petition a court to modify or lift the restriction pursuant to cy pres and equitable deviation.

Older, smaller funds can be released or modified by notifying the Attorney General of the intent to do so, without making a request to the court. As long as the account is less than $25,000 (or, in some states, $50,000 or $100,000) and more than 20 years old, the modification or release automatically takes effect in 60 days barring objection by the Attorney General, again, as long as it is in line with the donor's intent.

Conclusion

UPMIFA should prompt nonprofits to evaluate their spending policies and asset allocations to ensure they are maximizing their mission's resources. Donor impact also should be considered: Many donors are familiar with Sarbanes-Oxley and the increased demand for for-profit accountability, and they may seek similar accountability in their charities. UPMIFA can help nonprofits articulate to donors how their contributions will impact the organization's long-term mission.

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UPMIFA Makes a Difference

These examples are hypothetical. Lancaster Pollard strongly recommends that you discuss UPMIFA and your investment portfolio with your attorney and your investment advisor to devise an appropriate spending policy and manage your assets prudently.

Situation 1:
A hospital receives an endowment of $1 million in 1952 that the donor restricts to polio research. The donor has since died. UMIFA is not clear about whether cy pres is available to the hospital, and in many states, little case law on the subject exists.
The endowment remains on the books, but the hospital has been unable to utilize the resources.

UPMIFA Makes a Difference:
UPMIFA allows organizations to seek court approval to modify donor restrictions without fully removing them if, and only if, the restrictions are in the line of the donor's original intent. The hospital can ask the court to change the restrictions to use the fund for juvenile arthritis research and assure future donors of the longevity of their gifts.

Situation 2:
A donor bequeaths 10,000 shares of his company's stock to a skilled nursing facility. Under UMIFA, the guidelines for how to incorporate that donation into the investment portfolio were somewhat open to interpretation.

UPMIFA Makes a Difference:
UPMIFA requires that the stock donation be evaluated in terms of how it fits into the portfolio, with due consideration given to tax consequences, the expected total return of the portfolio, the relationship between distributions and the preservation of capital, and other factors.

Diversification of the single stock also should be considered as part of the duty to manage the portfolio, but if the nursing facility determines that the fund's purposes are better served by holding the stock, it can do so. UPMIFA puts more accountability on the boards of nonprofit organizations.

Situation 3:
A school has a $50 million scholarship endowment dedicated for low-income students. The endowment has lost all of its earnings and more in a bear market, causing the value to drop to $49 million. UMIFA did not allow nonprofits to tap the original gift amount, rendering the fund useless to incoming students who are more in need of scholarships than ever.

UPMIFA Makes a Difference:
UPMIFA allows nonprofits to responsibly tap that original gift up to an amount the organization deems prudent for the benefit of the fund's purpose, pursuant to careful evaluation of various factors. These include the impact to the fund's long-term viability and any defined presumptions of imprudence imposed by the state.

The ability to modify the school's endowment spending policy to accommodate for the down market means that students who otherwise would have had to forego college because of the economy can still rely on the school for financial aid.

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