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ENDOWMENTS AND MORE:
Issues and Ideas

Northern California Planned Giving Council

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Erik Dryburgh
Adler & Colvin
235 Montgomery Street, Suite 1220
San Francisco, CA 94104
(415) 421-7555

ADLER & COLVIN
A Law Corporation

ROSEMARY E. FEI
ROBERT A. WEXLER
ERIK DRYBURGH
INGRID MITTERMAIER
DAVID A. LEVITT
STEPHANIE L. PETIT
NANCY E. McGLAMERY
ERIC K. GOROVITZ

GREGORY L. COLVIN - SENIOR COUNSEL

STEVEN CHIODINI - OF COUNSEL
MATTHEW CLAUSEN - OF COUNSEL

235 MONTGOMERY STREET • RUSS BUILDING, SUITE 1220 • SAN FRANCISCO, CALIFORNIA 94104
TEL: 415.421.7555 • FAX: 415.421.0712 • WWW.ADLERCOLVIN.COM

The Law of Endowments
(The Uniform Prudent Management of Institutional Funds Act)

Erik Dryburgh

I. WHAT IS AN ENDOWMENT?

A. To a donor, an endowment is a sum of money given to a charity for charitable purposes, with only the "income" being spent and "principal" being preserved.

B. To an accountant, it is a fund which is "permanently restricted."

C. To a lawyer, it is an institutional fund not wholly expendable on a current basis under the terms of the gift instrument.

D. Thus, a "true" endowment is one established or created by the donor. A board-restricted endowment (or "quasi-endowment") is created when the Board takes unrestricted funds and imposes a spending restriction.

II. WHAT WAS UMIFA AND WHY WAS IT ADOPTED?

The Uniform Management of Institutional Funds Act (UMIFA) was a uniform law which provides rules regarding how much of an endowment a charity can spend, for what purpose, and how the charity should invest the endowment funds. UMIFA was the governing law in California through December 31, 2008. It was adopted because charities and their lawyers were unsure how to define "income" in the context of an endowment. Many looked to trust law, which generally defines "income" as including interest, dividends and the like, but defines gains as "principal." Thus, charities invested endowments in bonds and high-dividend stocks, but passed by investments with favorable growth prospects if they had a low current yield. Consequently, long-term yield suffered. The drafters of UMIFA thought charities should be able to spend a prudent portion of the gains earned by an endowment.

III. SO WHAT IS UPMIFA?

A. UMIFA is thought to be out of date, particularly as to management, investment, and spending issues. In particular, the post-dot.com "down" market resulted in many "underwater" endowments, exposing the flaws in the UMIFA spending rules.

B. UPMIFA ("Uniform Prudent Management of Institutional Funds Act") was approved by the National Conference of Commissioners on Uniform State Laws in July 2006, and has been adopted in virtually every state.

C. California adopted UPMIFA (Senate Bill 1329) effective January 1, 2009. It applies to funds created after that date, and to decisions made after that date for existing endowments (i.e., it will be "retroactive").

IV. HOW DOES AN ENDOWMENT GET CREATED?

A. An endowment fund is a fund not wholly expendable by the institution on a current basis under the terms of the applicable gift instrument. UPMIFA makes it clear that the term "endowment fund" does not include funds that the charity designates as endowment (these are "quasi-endowment" funds).

B. UPMIFA defines a gift instrument as being a "record" – information inscribed on a tangible medium or stored electronically – including an institutional solicitation, under which property is given. UPMIFA thus makes it clear that a gift instrument must be in writing, but expands the definition to include email. Governance documents, such as Bylaws, may be part of the gift instrument. A record is part of the gift instrument, however, only if the donor and the charity were, or should have been, aware of its terms.

V. HOW SHOULD A CHARITY INVEST ITS ENDOWMENT?

A. Investment is a matter of state law. In California, the Board is subject to the rules on prudent investments as set forth in both the Corporations Code and UPMIFA.

B. The Corporations Code provides that in making investments, a Board must "avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety of funds." This is an "old fashioned" and fairly conservative statement of the prudent investor rule. Fortunately, effective January 1, 2016, compliance with UPMIFA will be deemed to be compliance with the Corporations Code standard.

C. UPMIFA articulates a standard of care for both managing and investing an endowment. It requires the charity to consider the charitable purposes of the charity, and the purposes of the endowment fund. It requires the Board (and others responsible for managing and investing) to act in good faith and with the care of an ordinary prudent person, and notes that the charity may incur only appropriate and reasonable costs.

The charity must consider:

1. General economic conditions,
2. Effects of inflation and deflation,
3. Tax consequences,
4. The role of each investment in the overall portfolio,
5. Expected total return from income and appreciation,
6. The charity's other resources, and
7. The needs of the charity and the fund to make distributions and preserve capital.

D. UPMIFA provides that an individual investment must be analyzed in the context of the total portfolio and the overall risk-reward objectives, and that a charity can invest in any kind of property that is not inconsistent with the standard of care.

E. UPMIFA imposes a duty to diversify.

VI. HOW MUCH OF AN ENDOWMENT CAN A CHARITY SPEND?

A. UMIFA provided that "The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, both realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent …."

Net appreciation includes realized gains and unrealized gains.

Historic dollar value is "the aggregate fair value in dollars of (1) an endowment fund at the time it became an endowment fund, (2) each subsequent donation to the endowment fund at the time it is made, and (3) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the endowment fund."

Although UMIFA did not explicitly so state, most attorneys concluded that "income" (e.g., interest and dividends) could be spent as well (even with an "underwater" endowment).

B. UPMIFA makes a radical change and does away with the concept of "historic dollar value." UPMIFA allows a charity to appropriate for expenditure, or accumulate, so much of an endowment fund as the charity determines is prudent for the purposes for which the fund was established.

The charity must consider:

1. The duration and preservation of the endowment fund,
2. The purposes of the charity and the fund,
3. General economic conditions,
4. Effects of inflation and deflation,
5. Expected total return from income and appreciation,
6. The charity's other resources, and
7. The charity's investment policy.

C. California's UPMIFA includes the optional provision stating that an appropriation of greater than 7% of the average FMV of an endowment (averaged over the last three years) is presumptively imprudent.

VII. WHAT ABOUT DELEGATION?

UPMIFA allows a charity to delegate management and/or investment decisions to agents. The charity must act prudently in selecting the agent, establishing the scope of the delegation, and reviewing the agent's actions. A charity that does so is not liable for the actions of the agent. However, the agent is held to a "reasonable care" standard and is expressly made subject to appropriate court jurisdiction.

VIII. WHAT ABOUT CHANGING A RESTRICTION?

A. UPMIFA allows a charity to release or modify a restriction regarding management, investment, or purpose of a fund if the donor consents in writing.

B. If a purpose or use restriction becomes unlawful, impracticable, impossible to achieve, or wasteful, the court may modify the restriction in a manner consistent with the donor's intent. The Attorney General must be notified.

C. The court can modify a management or investment restriction if it has become impracticable or wasteful, impairs the management or investment of the fund, or (if due to unforeseen circumstances) the release would further the purposes of the fund. The Attorney General must be notified.

D. If a fund is less than $100,000 in value and over 20 years old, and the charity determines that a restriction on the management, investment, or use of the fund is unlawful, impracticable, impossible to achieve, or wasteful, the charity can (after notice to the Attorney General) release or modify the restriction. It must thereafter use the funds in a manner consistent with the donor's charitable purposes.

IX. WHAT ABOUT ENFORCING SPENDING OR PURPOSE RESTRICTIONS?

A. The Attorney General can bring an action to enforce the terms of a restricted gift. Depending on the law governing the internal affairs of the charity, an officer, director, or even a voting member may be able to challenge a breach of trust. *See, e.g.,* Cal. Corp. Code §5142 (for California nonprofit public benefit corporations).

B. What if the donor believes the institution is violating the use restriction? Some states have held that unless the donor reserves a right to enforce in the gift instrument, only the state Attorney General has legal standing (*Carl Herzog Foundation v. University of Bridgeport,* 699 A.2d 995 (1997)). Other states have concluded that a donor may have standing (*LB Research and Education Foundation v. UCLA Foundation,* 130 CalApp 4th 171 (2005)*; Smithers v. St. Luke's Roosevelt Hospital Center*, 723 N.Y.S.2d 426 (2001)).

C. A donor may consider building donor standing into the gift instrument. A power of reversion is likely to render the gift incomplete and non-deductible for income tax purposes; consider including a power to redirect the gift to another charity willing to abide by the restrictions in the event of default.

X. WHAT ABOUT THOSE ACCOUNTANTS?

A. In general, for accounting purposes, funds received as "true" endowments are classified as permanently restricted. Funds subject to a restriction that the Board can satisfy – such as a timing restriction or purpose restriction – are classified as temporarily restricted. Funds received with no donor-imposed restrictions are classified as unrestricted.

B. FASB Staff Position 117-1 sets forth guidelines for reporting endowments governed by UPMIFA. It states that a charity should classify "all or a portion" of an endowment as permanently restricted net assets, based upon explicit donor restrictions (if any) or what the Board determines must be retained permanently. For example, a Board could determine that UPMIFA requires it to maintain the "historic dollar value" of its endowments. The value of an endowment in excess of the amount reported as permanently restricted is to be reported as temporarily restricted, until such time as some amount is "appropriated for expenditure," at which time that amount becomes unrestricted. FSP 117-1 also requires disclosure of relevant information, including a charity's spending policy and investment policy.

C. FASB 124 requires that distributions from the endowment, and losses suffered by the endowment, be taken from the endowment portion of the temporarily restricted asset class first (until it goes to zero), then from the unrestricted asset class. Put another way, the amount reported as permanently restricted funds would not change if there is a significant investment loss; the loss would reduce the temporarily restricted and the unrestricted asset classes.

D. The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-14, *Not-for-Profit Entities (Topic 958), Presentation of Financial Statements of Not-for-Profit Entities* on August 18, 2016. The ASU makes several changes relevant to endowments:

1. Present two classes of net assets—net assets with donor restrictions and net assets without donor restrictions—instead of unrestricted, temporarily restricted, and permanently restricted, and present the changes in these two classes on the statement of activities.

2. Disclose the amount, purpose, and type of board-designated net assets.

3. Classify the underwater amounts of donor-restricted endowment funds in net assets with donor restrictions. The update also requires disclosure of the aggregate fair value of underwater funds, the original gift amount, and the board policy and decisions made to spend, or not spend, from such funds during the year.

4. Use the placed-in-service approach (donor restrictions are released as assets are placed in service) for gifts of cash or other assets restricted for acquisition or construction of a long-lived asset such as property, plant, and equipment.

The ASU is effective for fiscal years beginning after December 15, 2017; early adoption is permitted.

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The Uniform Prudent Management of Institutional Funds Act: What We Have Learned So Far…

Erik Dryburgh

I. Review the Gift Instruments

Review for specific spending language – beyond "spend income, interest and dividends, don't spend principal"

Three categories of endowments:

- Those with a specific spending limitation
- Those governed by the UPMIFA spending rule
- Quasi-endowment

Need to review:

- Donor gift letters and instruments
- Charity solicitations
- Perhaps charity governing documents

May need to consult:

- An attorney regarding gift instrument language – there is lots of "gray" between "spend income" and "don't spend per UPMIFA"
- The donor to discuss on the "interpretation" of his/her gift language
- The Attorney General's Office

II. Decide Spending Approach

Endowments with a specific spending rule:

- Abide by the rule
- Segregate and track gift separately

Endowments subject to UPMIFA:

- Remember it is a default rule of construction
- General rule – spend that which is "prudent", considering 7 factors
- 7% of fair market value "cap"

Process:

- Board to review the UPMIFA factors
- Board to review facts and circumstances of each fund
- Document decision process
- Goal is to demonstrate Board met its standard of care
- Note this should be an annual process

Possible options:

- Continue to spend per past policy
- Decrease spending
- Don't invade "historic dollar value"
- Spend more during time of need, less when flush
- Different spending amounts for different funds?

III. Accounting Issues

Board to decide the amount that "must be retained permanently consistent with relevant law", which is classified as Permanently Restricted. Note the accounting rules are changing effective January 2018.

Board to review what to disclose on Financial Statements

IV. Review endowment policy

Update for UPMIFA

Re-visit dollar-minimums for:

- Naming rights
- Restricted purpose
- Separately negotiated fund agreement

V. Review Investment Policy

Update for revised UPMIFA prudent investor rules

Focus on meeting standard of care, and Board's ability to rely on experts

VI. Review Gift Acceptance Policy

IRS Form 990 now inquires about GAP for "nonstandard" gifts

VII. Disclose Endowment Terms to Donors

Take the opportunity to contact donors

Put the endowment policy on the web

Offer sample bequest language: "I leave $_____ to Charity X, to be held and administered per the terms of The Charity X Endowment Fund"

VIII. Release of Restrictions

Address funds with unwanted/unworkable restrictions:

- Release or modify with donor consent
- Secure Probate Court order modifying purpose/use restrictions
- Secure Probate Court order modifying management or investment restrictions
- Release or modify restrictions on "old and small" funds

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ENDOWMENT ALTERNATIVES FOR RELUCTANT DONORS

Erik Dryburgh

The Virtual Endowment

Attractive to a donor who wants to make an endowed gift now, has high current income, but doesn't have the necessary principal amount.

Essentially a binding pledge for the desired endowment principal amount (payable in a specified number of years or even at death) coupled with a binding pledge to pay (for example) 5% of the principal amount every year until the principal is paid.

The Mortgage Endowment

The donor essentially pays his endowment amount over time. Using the endowment principal amount, a payment term, and an interest rate, you can calculate the required annual payment using a mortgage amortization program.

Revocable Endowment

Essentially, a Grantor Reversionary term-of-years CLT. Donor gets an upfront income tax deduction, charity gets an annual annuity payment for the term-of-years, and at the end – the donor can either roll the gift over into a new CLT or take the funds back.

Summary of Accounting Standards Update 2016-14 Not-for-Profit Entities:

Presentation of Financial Statements of Not-for-Profit Entities

Effective for Years Ending December 31, 2018 or Later

	Current Standards	New Standards	Impact
Net Asset Classes	**Three** net asset classes (***unrestricted, temporarily restricted, and permanently restricted***).	**Two** net asset classes (***without donor restrictions and with donor restrictions***).	• Simplified financial statement presentation and more understandable for readers. • Additional details may still be disclosed.
Donor-Restricted Endowments	Donor-restricted endowments could have a portion of the balance in any of the three net asset classes, which is not easily understood.	The entire donor-restricted endowment balance (i.e. the original gift or corpus, cumulative earnings, or underwater balance) is grouped together in the ***with donor restrictions*** net asset class.	• Footnote table disclosures have been reformatted, but still provide similar information about the balances of the original gift and accumulated gains. • Simplifies the accounting by recording it all in the same net asset class.
Board Designated Net Assets	Disclosing information about board designations is currently **optional** for footnote disclosure or financial statement presentation.	**Requires** disclosure of amounts and purposes of internal governing board designations, appropriations, and similar actions that result in self-imposed limits on the use of resources without donor-imposed restrictions, especially when a measure of operations is included.	• If board designations are used to manage operating results, the new requirements will provide insight into how this is done. • Board designations affect the perception of an organization's liquidity, so it may affect how or where to include disclosures.
Functional Expenses	Only certain types of nonprofits are required to present a statement of functional expenses with information about expense amounts by both natural and functional classifications in one place.	**All** nonprofits are required to present together in one place the amounts of expenses by both their natural and functional classifications. The location of the presentation is **optional** and may be presented in the statement of activities, a separate statement of functional expenses, or a financial statement footnote.	• Consistent treatment and enhanced comparability for all nonprofits. • Additional details for readers to question. • Provides a more complete picture of how resources are utilized by the organization.
Expense Allocations	There is very little guidance currently from the FASB on allocating shared costs between program and supporting activities. Disclosures about the methods of allocating costs between program and support functions is optional.	The definition of management and general activities has been expanded to include the concept of ***direct conduct or supervision*** in order to allocate costs to other program or support functions, with four very common types of allocable costs. You must also disclose additional **qualitative details** about the method(s) used to allocate costs among program and support functions.	• More costs are likely to be considered management and general that don't meet the definition of direct conduct or supervision (e.g. CEO, CFO, HR department, and grant accountant). • Qualitative disclosures will provide additional details on the allocation bases used for costs (i.e. time estimates, square feet, etc.).
Investment Returns and Expenses	Investment-related expenses may be presented either as netted against investment returns or as part of total expenses. Also, the components of investment returns, including expenses, are required to be disclosed in the footnotes.	Investment-related expenses should be netted with investment returns. Investment-related expenses include both external and direct internal expenses. The separate disclosure of investment expenses is no longer required.	• Consistent treatment and disclosure for all nonprofits. • Use judgment, since allocating external and direct internal expenses reduces general and administrative expenses, but it will also reduce net investment returns and performance.

	Current Standards	New Standards	Impact
Statement of Cash Flows	You may present the statement of cash flows using either the indirect or direct method. If the direct method is used, an additional reconciliation of operating cash flows using the indirect method is required. Currently, the indirect method is mostly used in practice.	You may still present the statement of cash flows using either the indirect or direct method. However, the requirement for a reconciliation of indirect operating cash flows is no longer required if the direct method is elected.	• Reduced a duplicative requirement to encourage a broader use of the direct method. • FASB trying to emphasize the direct method as more meaningful information for stakeholders.
Capital Gifts	Capital gifts of cash or other assets to be used to acquire or construct a long-lived asset are initially record as temporarily restricted gifts. Absent any explicit donor stipulations, the restriction may be released by electing one of **two options**, **1)** the placed-in-service approach; **or 2)** release the restricted balance ratably over the estimated useful life of the related asset.	Absent any explicit donor stipulations, release restrictions on gifts of cash or other assets to be used to acquire or construct a long-lived asset using the **placed-in-service approach** (i.e. release the entire balance of restricted funds once the asset begins depreciating) and reclassify any amounts from *net assets with donor restrictions* to *net assets without donor restrictions.*	• Consistent treatment and enhanced comparability for all nonprofits. • Placed-in-service approach is more balance sheet and liquidity focused. • If you used to release restrictions ratably, **review debt covenants** with lenders, since there will now be depreciation expense with no offsetting income for the ratable release of restrictions.
Liquidity Disclosures	No currently required liquidity disclosures. However, the balance sheet is expected to be sequenced based on the relative liquidity and financial flexibility of assets and liabilities.	Disclosures about liquid resources available to meet cash needs for general expenditures within one year of the balance sheet date by including **1)** ***qualitative information*** about how the organization manages its liquid resources; **and 2)** ***quantitative information***, either on the face of the balance sheet or in the notes that communicates the availability of financial assets at the balance sheet date to meet cash needs. Availability of a financial asset may be affected by (1) its nature, (2) external limits imposed by donors, grantors, laws, and contracts with others, and (3) internal limits imposed by governing board decisions.	• Equivalent to presenting a classified balance sheet, with tweaks for restricted or unavailable funds, and where working capital can be easily calculated is an option. • Expect donors and lenders to pay attention to these disclosures. • There is also a new going concern standard that could make this disclosure an important factor in a going concern analysis. • The FASB left some flexibility for organizations to explain how they manage and analyze liquidity.
Donor Restriction Disclosures	Disclosures are currently required for information about the nature and amounts of different types of donor-imposed restrictions.	The existing disclosure requirements have been enhanced to provide further details and examples on how to show the composition of net assets with donor restrictions at the end of the period and how the restrictions affect the use of resources.	• Disclosures of donor restricted balances will likely be broken down at a further level of detail than before.
Endowment Disclosures	• Underwater endowments are considered unrestricted net assets and disclosures are required to present the balance of any underwater endowment balances. • A disclosure is required for the reconciliation of beginning and ending endowment balances and requires the breakout of the components of the associated investment returns.	• Additional disclosures required about underwater donor-restricted endowment funds, including policies about spending from underwater endowments, the fair value of underwater endowments, original gift amounts, and the balance of deficiencies of underwater endowments. • Disclosures related to a reconciliation of beginning and ending endowment balances **no longer requires** a breakout of the components of the associated investment returns.	• Underwater endowment balance disclosures provide comparable information as before the new standard. Policy disclosures give further insight into endowment spending. • New reconciliation disclosures will simplify presentation.