Public Finance & Tax-Exempt Organizations Alert

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New Law Gives Washington Charitable and Educational Institutions Flexibility in Managing Endowments

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) was passed by both houses of the legislature last week and is expected to be signed into law shortly. The new law will go into effect on July 1, 2009, but an emergency clause in the bill permits institutions to elect to be governed by the new law immediately, if they so choose.

UPMIFA, a model act already adopted by a majority of states, gives colleges, universities, hospitals, foundations, and other nonprofit institutions more flexibility in managing their endowments and other institutional funds. The new law updates the 35-year-old Uniform Management of Institutional Funds Act (UMIFA) (codified at Chapter 24.44 RCW). UPMIFA establishes a new, more modern standard of prudence for the management of invested charitable funds. Like UMIFA, UPMIFA applies to organizations organized and operated exclusively for charitable purposes, including nonprofit corporations and government subdivisions or agencies, as well as certain kinds of charitable trusts.

Current Washington law permits a charitable institution to spend that portion of an endowment fund’s appreciation its directors deem prudent, so long as the value of such fund does not dip below its “historic dollar value.” Historic dollar value is defined as the fair value in dollars at the creation of the fund plus the value of any later gifts or accumulation reinvested as endowment principal. When UMIFA was enacted in the early 1970s, it revolutionized the way colleges, universities, and other nonprofit institutions managed their endowment funds, enabling those institutions to use a total return method of accounting to invest more aggressively for long-term growth. UMIFA’s focus on historic dollar value, however, has proven to be cumbersome, particularly during periods of market volatility. Under UMIFA, if the value of a donor-restricted fund drops below its historic dollar value (known as going “underwater”), no portion of that fund may be spent. This result is likely to hamstring nonprofit institutions at times when need is greatest and frustrate a donor’s intent to provide funds to be used for a charitable purpose.

UPMIFA eliminates historic restrictions on endowment spending in favor of a less restrictive prudence standard. Under UPMIFA, a charity is not limited to spending only amounts above the historic dollar value of donor-restricted endowment funds. Drawing on standards of care and prudence applicable to fiduciaries, UPMIFA permits charities to spend that portion of their endowment funds they deem prudent, subject to donor intent. Charities are instructed to consider various factors in deciding what portion of a fund is prudent to spend, taking into account general economic conditions, the other resources of the institution, and the donor’s intent to see the fund continue in perpetuity.
UPMIFA also makes it easier to modify burdensome or outdated donor restrictions on certain older and smaller endowment funds. In addition, UPMIFA provides a clearer standard of conduct for investing than is found under UMIFA, particularly as applied to diversification and pooling of assets, and the delegation of investment management authority to outside service providers. These standards of conduct are default provisions, which may be modified by donor intent as expressed in the terms of the gift instrument.

UPMIFA’s emphasis on acting in good faith should provide comfort to nonprofit boards and investment managers navigating a difficult investment climate, while the elimination of the historic dollar value concept gives institutions flexibility to respond to fluctuations in fund levels. Charitable and educational institutions in Washington will want to review and revise their investment and spending policies and related agreements as necessary to take advantage of changes in the law.