New Law Impacts Endowment Funds

Executive Summary

Ohio's version of the Uniform Prudent Management of Institutional Funds Act was signed by the Governor on January 6, 2009 and becomes effective June 1, 2009. The Act changes the law applicable to charitable endowments and in particular expenditures from endowment funds. The Act, amongst other changes:

- does away with the concept of historic dollar value;
- provides that an institution may expend so much of the endowment fund as the institution determines is prudent;
- provides an irrebuttable presumption of prudence for expenditures in any year of an amount not greater than 5% of the fund's value;
- provides more detailed provisions regarding the standard of care for managing and investing endowment funds; and
- provides more detailed provisions for the modification or release of a restriction contained in a gift instrument, and in certain circumstances, alleviates the need for a court action.

Introduction

On November 17, 2008 the Ohio House of Representatives passed Am. H.B. 522 (the "Law"), adopting the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). The Governor signed the Law on January 6, 2009, and it becomes effective June 1, 2009.

The Law modifies the Uniform Management of Institutional Funds Act ("UMIFA"), which was adopted in Ohio in 1975 and governs the management and investment of endowment funds under the control of non-profit, charitable institutions. The Law's primary changes are in the statutory definitions, the expenditure or accumulation of an endowment fund, the standards of conduct in managing and investing an endowment fund, and the release or modification of restrictions contained in a gift instrument.

Key Definitions

Under the Law, the definition of "Institution" is more comprehensive than under UMIFA and includes: (1) a corporation, governmental organization, business trust, estate, trust, partnership, limited liability company, association, joint venture, or public corporation organized and operated exclusively for "charitable purposes;" and (2) a trust that initially had both charitable and non-charitable interests and the non-charitable interests have terminated.

The Law defines "charitable purposes" as any purpose whose achievement is beneficial to the community, including the relief of poverty, the advancement of education or religion, the promotion of health, and the promotion of a governmental purpose.

The Law also modifies the definition of "Institutional Fund" to mean a fund that is held by an institution exclusively for charitable purposes. An Institutional Fund does not include (1) program related assets (i.e., assets held by an institution primarily to accomplish a charitable purpose of the institution and not primarily for investment), (2) a fund held for an institution by a trustee that is not an institution[*], or (3) a fund in which a beneficiary that is not an institution has an interest other than an interest that may arise upon a violation of or the failure of the purposes of the fund.

[*] The Ohio Institutional Trust Funds Act applies to such funds.

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The Law also retains the definition of an "Endowment Fund" ("an institutional fund or any part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis"), but adds that an endowment fund does not include assets that an institution designates as an endowment fund for its own use, often known as Board-designated endowment funds.

Expenditure or Accumulation of Endowment Funds

Under prior law, UMIFA authorizes the board to appropriate for expenditure so much of the net appreciation in excess of original value of the funds contributed to the endowment fund. Rather than trying to define income and principal, UMIFA uses the term "historic dollar value," which means the value of contributions made to an endowment fund, without increases or decreases because of investment results, inflation or anything else. Under UMIFA, a charity can spend from an endowment fund the amount of appreciation, including realized and unrealized gains, above the historic dollar value that the charity deems appropriate.

The Law does away with the concept of "historic dollar value," and instead provides that 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 an endowment fund is established.

In making a determination to appropriate or accumulate, the institution must act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and must consider the following factors:

- the duration and preservation of the endowment fund
- the purposes of the institution and the endowment fund
- general economic conditions
- the possible effect of inflation or deflation
- the expected total return from income and the appreciation of investments
- other resources of the institution
- the investment policy of the institution.

Similar to UMIFA, the Law further provides that terms in a gift instrument designating a gift as an endowment, or a direction or authorization in the gift instrument to use only income, interest, or dividends, or to preserve the principal intact, create an endowment fund of permanent duration (unless other language in the gift instrument limits the duration or purpose of the fund), but do not otherwise limit the authority to appropriate for expenditure or accumulate.

Under the Law, the appropriation for expenditure in any year of an amount not greater than 5% of the fair market value of an endowment fund creates an irrebuttable presumption of prudence. This provision of the Law, however, does not create a presumption of imprudence for an appropriation for expenditure that exceeds 5% of the fair market value of the endowment fund.

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Standards of Conduct in Managing and Investing Endowment Funds

Under prior law, UMIFA provides that in the exercise of the powers to appropriate appreciation, to make and retain investments, and to delegate investment management of institutional funds, board members must exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. In so doing, board members must consider the long and short term needs of the institution in carrying out its charitable purposes, its present and anticipated financial requirements, the expected total return on its investments, and general economic conditions.

The Law replaces the existing law with more detailed provisions:

- In managing and investing an institutional fund, an institution must consider the charitable purposes of the institution and the purposes of the institutional fund.

- Each person responsible for managing and investing an institutional fund must manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances (as opposed to exercising ordinary business care and prudence under circumstances prevailing at the time of the action or decision).

- In managing and investing an institutional fund, the following factors must be considered:

    - general economic conditions
    - the possible effect of inflation or deflation
    - the expected tax consequences, if any, of investment decisions or strategies
    - the role that each investment plays within the overall investment portfolio of the fund
    - the expected total return from income and the appreciation of investments,
    - other resources of the institution
    - the need of the institution and of the fund to make distributions and preserve capital.

- Management and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution.

- An institution must diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification.

- Within a reasonable time after receiving property, an institution must make and carry out decisions concerning the retention or disposition of the property or the rebalancing of a portfolio.

The Law also modifies existing law by providing that an institution may delegate the management and investment of an institutional fund to an agent. An institution must act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, in selecting an agent and establishing the scope and terms of the agent's authority. An institution must periodically review the agent's actions to monitor the agent's performance. An institution that complies with these requirements is not liable for the decisions or actions of an agent. The Law also provides that an agent, in performing a delegated function, owes a duty to the institution to exercise reasonable care to comply with the scope and terms of the delegation.

Release or Modification of Restrictions on Management, Investment, or Purpose

The Law modifies existing law by providing that if a donor consents, an institution may release or modify, in whole or in part, a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund. A release or modification cannot, however, permit a fund to be used for a purpose other than a charitable purpose of the institution.

The Law further provides that a court may modify *a restriction contained in a gift instrument regarding the management or investment of an institutional fund* if the restriction has become impracticable or wasteful, if it impairs the management or investment of the fund, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund. To the extent practicable, any such modification must be made in accordance with the donor's probable intention.

The Law also provides that a court, upon application of an institution, may modify *the charitable purpose of an institutional fund or a restriction contained in a gift instrument on the use of the fund* if the particular charitable purpose or restriction becomes unlawful, impracticable, impossible to achieve, or wasteful. Any modification must be made in a manner consistent with the charitable purposes expressed in the gift instrument.

In certain circumstances, a court action is not necessary where an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful. An institution may, after providing 60-days advance notice to the Attorney General, release or modify a restriction contained in a gift instrument if all of the following conditions are met: (1) the institutional fund subject to the restriction has a total value of less than $250,000, (2) more than ten years have elapsed since the fund was established, and (3) the institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument.

Effective Date

The Law takes effect June 1, 2009, and applies only to the following: (1) institutional funds established after that date; and (2) institutional funds existing on that date, but only with respect to decisions made or actions taken on or after that date.

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