IS THE LAW CAUSING CHARITIES TO DROWN BECAUSE THEIR ENDOWMENT FUNDS ARE NOW “UNDER WATER”?

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I. INTRODUCTION: THE PROBLEM

Like the rest of society, charitable institutions, from animal shelters to universities, have been suffering the effects of a major downturn in the economy not seen since the Great Depression. Unfortunately, charitable institutions may have their suffering compounded by laws or legal interpretations of them governing the management of their endowment funds.

One unfamiliar with the arcane legal aspects of this problem might think that endowment funds would be just the sort of cushion that charities would need to see them through difficult economic times. On the contrary, however, some people involved with the management of charitable endowment funds or otherwise involved with the laws or interpretation of them were of the opinion that, in many cases, permanent endowment funds cannot be used during this difficult period, because they are “under water.” By this, they mean that the assets, in today’s market, are valued substantially less than the value of the assets originally contributed when the endowment fund was established (also taking into consideration the value of subsequent contributions at the time or times they may have been made). Further, some people concluded that if a fund is “under water,” then said fund, including any income generated by said fund, may not be used to support the intended charity until such time as the value of the fund as when contributed re-emerges from the troubled financial waters. In other words, before a fund can be used to support its intended charity, its dollar value would have to equal or exceed the dollar value of assets when contributed to it, originally and subsequently. This could mean that if endowment funds were established or received by contributions at the time when the market was at a high point, such as in 2006, it might take ten years or even longer, to return to

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those valuations.\textsuperscript{1} In the meantime, the charity could be absolutely devastated, unable to use its own endowment fund.

II. THE ORIGINS OF THE PROBLEM: THE UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT ("UMIFA")

How could such an odd situation exist? Before the 1970s, many charities used traditional trust accounting principles in regard to their endowment funds. By endowment funds, I mean funds established by a donor to a charity in which the principal or corpus of the fund is regarded as being held in perpetuity or for at least a long number of years. The fund’s assets, being its principal or corpus, should generate income, either through interest or dividends, or by other means, which income would be used to support the intended charity. On the other hand, capital gains would be allocated to the principal, and could not be used for support purposes, but would increase the value of the permanent endowment fund, hopefully generating higher future income. In this era, trustees dealing with these funds tended to invest in conservative investments, such as government bonds and the like.

However, in the 1960s, a growing concern existed as inflation rose, bond values fell, and the value of equities increased. Therefore, the Ford Foundation commissioned a study of endowment funds by William Cary and Craig Bright.\textsuperscript{2}

The Cary and Bright study indicated that it might be better for charities if certain corporate accounting principles were utilized to govern endowment funds rather than traditional trust accounting allocations above described. In this way, the managers of charitable endowment funds could look to the rising values in the equity markets and take advantage of the general appreciation in those markets which has, indeed, occurred from those times until 2007. Instead of being restricted to interest, dividends, and the like, capital gains, both realized and unrealized, could be utilized in calculating income for distribution purposes. Thus, in 1972, utilizing the observations of Cary and Bright, the National Conference of Commissioners on Uniform State Laws drafted the Uniform Management of Institutional Funds Act\textsuperscript{3} ("UMIFA"), which was eventually adopted by forty-seven states.\textsuperscript{4} Nebraska adopted UMIFA in 1996. See Neb. Rev. Stat. sections 58-


\textsuperscript{4} Gary, \textit{supra} note 2, at 1287-88.
601 to 58-609, which have now been repealed.\textsuperscript{5} Thus, as was provided in section 3 of UMIFA, the governing board of a charitable institution "may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar of the fund as is prudent . . . ."\textsuperscript{6}

Commensurate with this development was the adoption by many charities of a "total return" policy in which distribution to a particular charity from its endowment fund would encompass the rising value of equity investments as reflected in the appreciating equity markets. The concept of "total return" investing is not defined specifically in UMIFA. For purposes of this Article, a "total return" policy means generally, distributions or expenditures from an endowment fund, taking into consideration not only the income but also full appreciation of the whole investment portfolio at an appropriate risk level.\textsuperscript{7}

The problem facing the charities arises from the phrase "the historic dollar value of the fund," as above quoted from section 5 of UMIFA.\textsuperscript{8} That phrase is more specifically defined by section 2(5) of UMIFA\textsuperscript{9} as follows:

Historic dollar value means the aggregate fair value in dollars of (a) an endowment fund at the time it became an endowment fund, (b) each subsequent donation to the fund at the time it is made, and (c) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the fund.\textsuperscript{10}

This provision is now wreaking havoc in the charitable sphere. For example, in Massachusetts, the Audubon Society's endowment fund, although substantial, lost twenty-eight percent of its value in 2008, and thus, a significant portion of it cannot be tapped for spending. This required the Audubon Society to furlough naturalists at its sanctuaries and science centers. The Massachusetts Society for the Prevention of Cruelty to Animals had to close three of its seven animal shelters. Brandeis University threatened to close its Rose Art Museum and sell its collection because "Massachusetts law made it difficult to use much of its endowment, which recently totaled $549 million

\textsuperscript{5} L.B. 136, Neb. Unicameral, 100th Leg., 1st Sess. (2007).
\textsuperscript{6} NEB. REV. STAT. § 58-603 (2009).
\textsuperscript{7} For a more detailed examination of this concept, see, for example, Ronald R. Volkmer, Nebraska's Updated Principal and Income Act: Apportioning, Allocating, and Adjusting to the New Trust World, 35 CREIGHTON L. REV. 295 (2002), and the references therein contained.
\textsuperscript{8} NEB. REV. STAT. § 58-603 (repealed 2007).
\textsuperscript{9} § 58-602(5) (repealed 2007).
\textsuperscript{10} § 58-602(5) (repealed 2007).
after posting a 25% decline since June."\textsuperscript{11} Thus, even with severe declines in market value, the mentioned charitable institutions still have substantial endowment funds. However, the law renders the use of those funds impossible until sometime in a possibly distant future when they may, if ever, re-emerge above water. Thus, for example, even though Brandeis University still has a $549 million endowment fund, and even though that fund still produces some income, there can be no distributions from the endowment fund for support of the university until such time the fund recovers its twenty-five percent loss. Who knows when that may occur? In the meantime, many charitable activities will either be destroyed or severely curtailed. Yet, those are the very activities for which donors made their contributions.

While the UMIFA drafters were probably very well intended and wanted to ensure that permanent endowments remained permanent, nevertheless, they made a mistaken assumption. They assumed that the equity markets, despite a few minor dips here and there, would forever go onward and upward. No thought was given to a meltdown the size of which we have experienced and from which we may not recover for a decade or more.

Of course, it was not just the legal solons who were mistaken. They simply followed the opinion of many, and perhaps most, economists and those involved with the financial functioning and direction of our economy.\textsuperscript{12} They were sure that with their new and elegant mathematical formulas and theories about economic behavior, they could march with abundant confidence into a continuing prosperous future.

III. THE LEGAL CORRECTION: THE UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT ("UPMIFA")

Fortunately for Nebraska, and for many other states, the Uniform Management of Institutional Funds Act\textsuperscript{13} ("UMIFA") has been repealed. In Nebraska, in 2007, it was replaced by the Nebraska Uni-


\textsuperscript{13} 7A U.L.A. 484 (2006).
form Prudent Management of Institutional Funds Act,14 ("UPMIFA").15

UPMIFA eliminates the "historic dollar value" requirements of UMIFA. In a prefatory note to UPMIFA, the National Conference of Commissioners on Uniform State Laws, stated: "UPMIFA improves the endowment spending rule by eliminating the concept of the historic dollar value and providing better guidance regarding the operation of the prudence standard."16

It is worth noting that UPMIFA was not drafted, as far as I know, with any anticipation of the severe economic downturn which we are now experiencing. Indeed, reading the commentary to the various sections of UPMIFA, one can detect that the same economic expectation of an onward and upward direction was still present in the minds of the drafters. For example, in commentary to section 4 of the UPMIFA17 is the following:

When the institution considers the purposes and duration of the fund, the institution will give priority to the donor's general intent that the fund be maintained permanently. Although the Act does not require that a specific amount be set aside as 'principal,' the Act assumes that the charity will act to preserve 'principal' (i.e., to maintain the purchasing power of the amounts contributed to the fund) while spending 'income' (i.e. making a distribution each year that represents a reasonable spending rate, given investment performance and general economic conditions). Thus, an institution should monitor principal in an accounting sense, identifying the original value of the fund (the historic dollar value) and the increases in value necessary to maintain the purchasing power of the fund.

Notwithstanding the above language, however, the Commissioners also recognized that under UMIFA, the necessity of maintaining the "historic dollar value" could also be a very difficult and sometimes

16. Id. at 3.
unworkable concept. Thus, the Commissioners were wise enough to make the following criticism of UMIFA:

The Act [UMIFA] does not provide clear answers to questions a charity faces when the value of an endowment fund drops below historic dollar value. A fund that is so encumbered is commonly called an ‘underwater’ fund. Conflicting advice regarding whether an organization could spend from an underwater fund has led to difficulties for those managing charities. If a charity concluded that it could continue to spend trust accounting income until a fund regained its historic dollar value, the charity might invest for income rather than on a total-return basis. Thus, the historic dollar value rule can cause inappropriate distortions in investment policy and can ultimately lead to a decline in a fund’s real value. If, instead, a charity with an underwater fund continues to invest for growth, the charity may be unable to spend anything from an underwater endowment fund for several years. The inability of a charity to spend anything from an endowment is likely to be contrary to donor intent, which is to provide current benefits to the charity.\(^\text{18}\)

Common sense indicates that donors who establish permanent endowment funds intend that the charities that are the object of their beneficence be permanently supported. They do not intend simply to have a permanent fund “come hell or high water.” Therefore, it is the permanency of support that should be of primary concern to those entrusted to management of endowment funds. Any action which cuts off all levels of support until historic values are recovered would be against the intent of most donors and would be a disaster to the affected charities.

Thankfully, the UPMIFA's language is flexible enough to provide that endowment fund managers can make decisions which balance the need to maintain some permanency in the corpus of a fund with the ongoing need to support the intended charity. Appropriation for expenditures from the fund are now governed by seven factors subject to the intent of a donor expressed in an instrument conveying the gift. The seven factors have been codified in section 4 of the UPMIFA,\(^\text{19}\) which reads as follows:

Appropriation for expenditure or accumulation of endowment fund; rules of construction.

(a) *Subject to the intent of a donor expressed in the gift instrument*, an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institu-

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tion determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. Unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution. In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following factors:

1. the duration and preservation of the endowment fund;
2. the purposes of the institution and the endowment fund;
3. general economic conditions;
4. the possible effect of inflation or deflation;
5. the expected total return from income and the appreciation of investments;
6. other resources of the institution; and
7. the investment policy of the institution.

(b) To limit the authority to appropriate for expenditure or accumulate under subsection (a) of this section, a gift instrument must specifically state the limitation.

(c) 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, dividends, or rents, issues, or profits, or to preserve the principal intact, or words of similar import:

1. create an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund; and
2. do not otherwise limit the authority to appropriate for expenditure or accumulate under subsection (a) of this section. (Emphasis added).

The comments by the drafters to this section, to a degree, recognize the balancing of responsibilities: “UPMIFA clarifies that in making spending decisions the institution should attempt to ensure that the value of the fund endures while still providing that some amounts be spent for the purposes of the endowment fund.”

In my opinion, that statement would have been better made if it eliminated the term “value.” The reason that the drafters used that term is because they were concerned about loss of purchasing power of a fund due to inflation. Inflation, however, while a legitimate concern, is not now the primary problem. In any case, it is the language of the law itself that governs, not the commentary. As stated above, the
commentary was written based upon assumptions that are no longer true and which, certainly, did not anticipate events which have now come to pass.

IV. WHERE DO WE GO FROM HERE?

Given that section 4 of Uniform Management of Institutional Funds Act\textsuperscript{22} ("UMIFA")\textsuperscript{23} has this flexibility, how shall endowment fund managers now operate in making allocation or support decisions, and in general? That is not an easy question to answer. Managers are going to have to re-examine their investment strategies. To what extent should a fund include equities in its investment portfolio? What role should appreciation have as compared to income generation? Is the concept of a total return policy still more sensible than that which traditionally prevailed under earlier trust accounting? Given the current economic situation, how much support can be given to the intended charitable beneficiary, and on what basis can that support level be determined? However, these are essentially economic or policy issues. They are not legal matters, as such, although the law may touch upon them.

The basic legal requirement is that all of the seven factors in section 4 of the Uniform Prudent Management of Institutional Funds Act\textsuperscript{24} ("UPMIFA") should be taken into consideration. Even more than that, there must be the recognition that the whole decision-making process must be balanced with "the intent of [the] donor expressed in the gift instrument," which would usually imply continued support, even in very difficult economic times.\textsuperscript{25}

For the moment, until policy issues and the economic situation can become more clarified, allocation decisions still must be made. Further, recognition must be given to the fact that most endowment fund agreements, at least in my experience, still employ the terms "principal" and "income." For example, such agreements usually state that "In no event shall any portion of the principal of this Fund be invaded or expended." Such agreements also may include words indicating that the endowment will stand as a perpetual memorial to honor the donor or benefactor, or, similar language indicating an intent that the endowment be long lasting.

Then, in a very typical agreement, there will be directions as to the income. For example, "The annual net income of the fund . . . shall be used for the following purpose . . . ." A typical endowment fund agreement will go on to specify a particular charitable activity, or set of activities, that the donor wants funded.

Many newer agreements may also incorporate the allowance of a "total return" policy. Even those agreements, however, also have directions as to required use of the "income."

No matter how income may be defined, the endowment agreement always spells out how income shall be distributed, usually on some periodic basis such as annually, and for what specific charitable purposes. From my experience, it is those charitable activities that are uppermost in a donor's mind when that donor establishes endowment funds or contributes to an established fund. The donor is looking at the food and clothing that is going to be distributed to the poor, the children that are going to be served by the camp, the animals that are going to be rescued by the shelter, or the students that are going to be assisted by scholarships. It is these charitable activities that they want perpetually funded and perpetually supported.

Donors may also be concerned about the maintenance of the purchasing power of their endowment funds, as some of the above-quoted comments in the UPMIFA suggest. However, those concerns are secondary to the primary purpose of continued support.

Admittedly, with the adoption of a total return policy, the terms "principal" and "income" can sometimes be blurry. Nevertheless, an endowment fund does contain actual assets, regardless of the current value of what those assets may be. Further, and typically, even in a down market, some of those assets may be producing a return, whether they are dividends, interest, or the like. These items of income may be very small, but they can still be identified in an investment portfolio, even with a total return policy. Therefore, it would still be possible to continue to support the intended charity by allocating eighty-five percent of that annual income to it.

In my opinion, at a minimum, endowment fund managers are required, unless an agreement were to state otherwise, to allocate whatever the income is of an endowment fund, under traditional concepts of income, to the intended charity. This would even be true under the prior law, UMIFA. The "historic dollar value" restriction under UMIFA, applied only to the appreciation of assets realized and unrealized. It did not apply to items of income as traditionally understood. Consequently, if an endowment agreement requires

27. Id.
that the annual net income of any endowment fund "shall be used" for the charitable activity, then those funds must be made available to the intended charity.

Section 513(c) of the New York Not-For-Profit Corporation Law is similar to, although not identical with, UMIFA. The Department of Law of the State of New York stated:

Pursuant to section 513(c) of the N-PCL, the value of the assets when given, known as the historic dollar value, may not be expended by the corporation. Instead, the assets must be invested, and the income – traditionally, interest, dividends, rents and royalties – is available for expenditure, even if the value of the principal drops below historic dollar value, whether because of specific investment losses or general decline in market values. However, in cases where the endowment fund principal has depreciated below the historic dollar value, the board of directors of the corporation may, if consistent with the gift instrument, prudently determine not to expend this income until the historic dollar value is restored (Emphasis added).28

Typical endowment agreements that I am familiar with do not contain a provision allowing the withholding of income until the historic dollar value of assets may be restored. Also, I would not recommend such a provision.

Under the new law, section 4 of UPMIFA29 quoted above, the same result should be obtained. At a minimum, the income produced by assets of the endowment fund should be appropriated and made available to the intended charity, unless the endowment agreement would provide otherwise.

Notwithstanding the foregoing, however, as a practical matter, the above-described approach of providing income to the intended charity may be woefully insufficient vis-à-vis the needs of the charitable institution, particularly during this current economic crisis. Depending upon the investments in a portfolio, it is possible that very little income would be available to the charity. It is even conceivable that there might be no income at all if an investment portfolio were only invested in equities that paid no dividends.

A better option, at least for the interim, might be to value the endowment fund as of, let us say, the beginning or the end of the year, and distribute a percentage of that value in support of the intended charity. This approach is referred to by some as a "unitrust" policy. I

believe that this option would be in harmony with the language of the type of endowment agreement quoted above, and, at the same time, maintain some support level for the charity, although it would be most likely at a level below what may have been enjoyed in the years before the current meltdown. This approach would be legally permissible under UPMIFA:

In the past, many charitable organizations have adopted spending policies for general endowment funds based on a percentage of the value of the fund, typically between 4% and 6% annually. Prior to the UPMIFA, these policies were permitted, so long as the spending did not reduce the value of the general endowment fund below its historic dollar value. The UPMIFA does not require the charity to maintain endowment funds at any minimum level. After the adoption of the UPMIFA, the 4%-6% spending formulae should be prudent under the general prudence standard, without any minimum floor on the value of the endowment fund.30

Both of the above approaches would maintain a sense of permanency of the endowment fund, yet, at the same time, also provide some form of current support for the intended charity. While decisions regarding these matters will not be easy ones, they should be made soon so that the charities affected may know what to expect in terms of their activities during the coming year. However, endowment fund managers will have to then grapple with the issues previously mentioned. What should their investment policies now be? Is the concept of a total return policy still worthwhile? Should it be modified? Should it be abandoned? The law does not provide specific guidance as to how these decisions should be made except to caution the managers that under UPMIFA: “[E]ach person responsible for managing and investing an institutional fund shall 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.”31

Of course, what is “prudent” today may also be regarded as something of a mystery. If endowment fund managers had followed very conservative and traditional approaches, investing primarily in assets such as government bonds and the like, they might be hailed as heroes today. Yet, several years ago, they might have been reviled for not taking advantage of what appeared to many to be the ever-increasing trajectory of appreciation in the equity markets. Legally speaking,

the managers must act “in good faith” and according to the standards set forth in section 3 of UPMIFA. In today’s perplexing economic world, we can only wish those decision-makers good luck.

V. CONCLUSION

There are lessons to be learned from this experience. No matter how sophisticated or advanced some may regard the “science” of jurisprudence or the dismal “science” of economics, there is simply no replacement for common sense.

As the old adage goes, whatever goes up may also come down. It should never again be assumed that we can accurately predict the economic future by the use of some mathematical formulas such as those based on the efficient market hypothesis. It is hubris to believe that all of the variables effecting or affecting human behavior can be encapsulated in some grand theory no matter how elegant and appealing. Therefore, given the vagaries of human existence, our laws should be written with enough flexibility to allow those operating under them to proceed with common sense.

In this specific instance, common sense ought not to be drowned under water in order to meet the unintended consequences of defective legislation or legal interpretation. Donors who contribute to charitable endeavors and establish endowment funds for their support usually want their funds to support their intended beneficiaries through good times and bad. It is this intent that should predominate. Therefore, those entrusted with the management of said funds should be able to use their best judgment so that the donative intent of continued support is preserved even in recessionary times.

As Paul Krugman observed:

This seems . . . like a good time to recall the words of H.L. Mencken: ‘There is always an easy solution to every human problem – neat, plausible and wrong.’

When it comes to the all-too-human problem of recessions and depressions, economists need to abandon the neat

33. The late Professor John P. Roche, who taught politics at Brandeis University, and then at Tufts University, vociferously maintained that politics was an art and not a science. In my opinion, the same should be true of the law and economics as well.
but wrong solution of assuming that everyone is rational and markets work perfectly. The vision that emerges as the profession rethinks its foundations may not be all that clear; it certainly won’t be neat; but we can hope that it will have the virtue of being at least partly right.\(^{35}\)
