STROOCK

SPECIAL BULLETIN

New York Prudent Management of Institutional Funds Act

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Background

On September 17, 2010, New York enacted the New York Prudent Management of Institutional Funds Act ("NYPMIFA" or the "Act"), a modified version of the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). All of its requirements became effective immediately.

NYPMIFA imposes new duties on governing boards of New York-formed nonprofits, imposes new restrictions on the management of "institutional funds" held by such nonprofits, and liberalizes rules on endowment fund spending by such nonprofits.

Although the Act imposes some burdensome duties on all New York nonprofits, enactment of this new law comes as good news to nonprofits with "underwater endowments" (*i.e.*, endowments that have a current dollar value below the level in place at the time of the original grant), because some of the restrictions they faced in invading the "historic dollar value" of endowment funds are now liberalized.

This **Stroock Special Bulletin** highlights some of the key provisions of the Act and notes where they differ from the provisions of UPMIFA.

Restrictions on Management of Institutional Funds

Scope

UPMIFA, which has been adopted in every other state other than Florida, Mississippi and Pennsylvania, and NYPMIFA apply to all "institutions." Under UPMIFA, such term is limited to those organized and operated exclusively for charitable purposes. Under NYPMIFA, however, the term also includes all corporations as defined under the Not-for-Profit Corporation Law.[1] This means that the New York

Act, unlike UPMIFA, applies to all not-for-profit corporations formed in New York, whether or not charitable, including health service corporations, social clubs, athletic organizations, social welfare organizations, professional and civic organizations, business leagues and trade associations, among other forms of nonprofits, as well as traditional charities such as hospitals, educational institutions and arts groups.

It is our understanding that the Act does not apply to nonprofits formed in states other than New York. The enactment of NYPMIFA gives new nonprofits another reason why careful consideration should be given to forming in states other than New York.

Some provisions of NYPMIFA apply to all institutions, some apply to institutions that have "institutional funds" and others apply only to institutions that have endowment funds.

Definition of "Institutional Funds"

An institutional fund is defined as "a fund that is held by an institution." [2] The definition excludes: (a) program-related assets (*i.e.*, assets that are not for investment under the terms of the gift instrument but are primarily to accomplish a programmatic purpose of the institution – these are primarily tangible and real assets, such as buildings and equipment); (b) a fund held for an institution by a non-institutional trustee; or (c) a fund in which a non-institutional beneficiary has an interest (other than as a contingent beneficiary).

Neither the Act nor UPMIFA, however, defines the word "fund." Does it apply to all "funds" (*i.e.*, money), or does it only apply to investments held in some vehicle that constitutes a "fund." The law is unclear; although there is language in the law that implies that it only applies to vehicles designated as "funds," other language supports a view that it applies to all financial assets other than the specifically-exempted categories noted in the prior paragraph.

Although it appears that the word "fund" is intended to apply only to assets held for investment purposes, the reporter for UPMIFA has said that current operating funds are still an institutional fund even though held for only a short-term period, since they are being held for investment until spent. The prudent investment rules applicable to such short-term funds would be different than those applicable to long-term funds, focusing more on safety and availability. Accordingly, if that view is correct, "institutional funds" include all cash and other nonprogramatic liquid assets – regardless of how small or how soon they will be spent – as well as more traditional investment funds. This is one of many provisions in the law that would benefit from clarification. It is therefore safest to assume, for now, that the term "fund" applies, as a practical matter, to all financial assets other than as specifically exempted from the law.

Duties Imposed on Governing Boards

Both NYPMIFA and UPMIFA impose certain duties on nonprofits. NYPMIFA, however, includes language stating that all obligations imposed on the institution are imposed on, and shall be authorized by, the governing board.[3] Although management of the nonprofit will, no doubt, take the leading oar in recommending where and how to invest, the Act makes it clear that any major decisions have to be made by the board, or a board committee, subject to the ability to delegate certain decisions as discussed below.

The Board of Directors or a validly constituted Board committee (the "Board") of the nonprofit has the following obligations:

- If it is a New York-formed nonprofit, whether or not charitable and whether or not it has any institutional funds, the Board must adopt, adhere to and periodically review a written investment policy that sets forth guidelines on investments and delegation of investment functions that are in accordance with NYPMIFA.

  This provision does not appear in UPMIFA, so it does not apply to nonprofits formed under the laws of other states. There is no penalty in the statute for noncompliance with this requirement, and the statutory authority of the NY Attorney General to seek sanctions for violations of this requirement is unclear. At least initially, the Attorney General will engage in an education effort to make nonprofits aware of this obligation.

  We understand that the Charities Bureau of the Office of the Attorney General believes that almost all nonprofits have one or more institutional funds, whether small or large, and a nonprofit that does not currently have any institutional fund may have such a fund in the future. It has also expressed concerns that there has been a general lack of board involvement in asset management. As shown by the impact of the Madoff scandal on nonprofits, many boards were not aware of what they need to do with respect to their investments.

  We assume that the Bureau feels that the affirmative requirement to have an investment policy should help to force each organization to pay attention to these matters. We also understand that certain nonprofit advisory organizations will be preparing prototype or sample policies for consideration; it is advisable to await issuance of such policies before the smaller and mid-sized nonprofits formulate their own policy.

  The Charities Bureau has announced that it will be issuing guidance on various issues arising under NYPMIFA. Although there can be no assurance as to when that guidance will be issued, we understand that efforts are being made to issue it before year-end.

- In determining how to manage and invest an institutional fund, the Board must act "in good faith and with the care of an ordinarily prudent person" in similar circumstances and it has to assess at least the following eight factors: (a) general economic conditions; (b) the possible effects of inflation or deflation; (c) the tax consequences of investment decisions; (d) the role that each investment plays within the overall fund portfolio; (e) the expected total return from income and investment appreciation; (f) the nonprofit's other resources; (g) the needs of the nonprofit and the fund to make distributions and to preserve capital; and (h) any special value an asset has to the nonprofit's purposes. There is no statutory requirement to document such decisions in minutes or other company documents but it would be prudent to do so, to protect the directors from fiduciary liability.

- The Board needs to diversify its investments unless it prudently determines that special circumstances warrant non-diversification. This determination must be reviewed at least annually. In the same spirit, when the organization receives specific assets from a donor it must promptly assess whether those assets can be kept or should be sold to satisfy the organization's investment criteria and to maintain investment diversity.

- If the nonprofit has endowment funds (that is, funds in the nonprofit's investment portfolio that are not wholly expendable on a current basis under the terms of a specific gift instrument), in determining to appropriate some of such funds for a current use, the Board needs to assess the following eight factors: (a) the duration and preservation of the endowment fund; (b) the purposes of the nonprofit and the endowment fund; (c) general economic conditions; (d) the possible effect of inflation or deflation; (e) the expected total return from income and the appreciation of investments; (f) the nonprofit's other resources; (g) where appropriate, alternatives to expenditure of the endowment fund, giving due consideration to the effect that such alternatives may have on the nonprofit; and (h) the nonprofit's investment policy.

The Boards of New York nonprofits also need to keep full "contemporaneous" minutes or other records that reflect the consideration of each of these factors. According to comments made by the Charities Bureau, the minutes or other record should not be boilerplate, rote or merely conclusory – how much detail will generally be advisable remains to be seen.

The requirement set forth in clause (g) and the requirement to keep a documentary record of the decision process are provisions not found in UPMIFA.

New York also adopted an optional provision, applicable only to endowment funds established after passage of NYPMIFA, setting forth a rebuttable presumption that all appropriations in excess of 7% per year of the endowment (valued quarterly on the basis of not less than a five-year rolling average) are imprudent, irrespective of whether the rate of return of the endowment fund exceeded 7%. Thirteen other states (including California) also adopted some variation of that presumption. If the board determines to exceed the 7% threshold, it needs to document the justifications for its decision.

Liberalized Rules on Endowment Fund Spending

In addition to the requirements it imposes, UPMIFA and NYPMIFA liberalize the rules regarding endowment fund spending. Except as described in the next paragraph, a nonprofit no longer is obligated to maintain the historic dollar value (the amount contributed to the endowment by the original donor without any inflation factor – "HDV") of the fund and the Board can now appropriate as much of the endowment as it wants, including the unrealized appreciation of its assets (as long as the prudence standard described above is met and documented). Previously the nonprofit could only expend income (*e.g.*, rents, royalties, interest and dividends), any realized appreciation in the endowment fund (*i.e.*, gains on the sale of securities) and any unrealized appreciation with respect to readily marketable assets (*i.e.*, gains in the quoted value for the investment, such as exchange-traded stocks), so long as the board determined that such expenditure was prudent, after considering the charity's purposes, and provided that no such expenditures of appreciation would cause the fund to go below the HDV of the fund.

With respect to any gift instrument executed before September 17, 2010, a New York-formed nonprofit must provide at least 90 days prior written notice to the donor (using statutorily mandated language) before the first of any appropriations for expenditure. This notice must give the donor the choice of allowing the nonprofit to spend as much of its gift as is prudent or requiring that the nonprofit not spend below the historic dollar value of the gift. Similarly, when soliciting endowment contributions, the nonprofit must include a statement (using statutorily mandated language) that the endowment fund can be expended unless otherwise restricted by the gift instrument.

UPMIFA and NYPMIFA also establish a procedure by which a nonprofit may go to court and to the Attorney General (or, just to the Attorney General for endowments that are at least 20 years old and do not exceed $100,000 – or $25,000 in UPMIFA states), on notice to the donor, if available, to have restrictions lifted or modified in appropriate cases.

Finally, UPMIFA and NYPMIFA permit the Board to delegate the management and investment of an institutional fund to an external agent as long as the selection, compensation and termination of the external agent meet the prudence standard (as elaborated in the law) and, in New York, provided that all contracts must be terminable by the nonprofit on no more than 60 days notice. In New York, such engagements must be periodically reviewed based on the same criteria required for appointment. Under NYPMIFA, to meet the prudence standard, the Board must assess all possible conflicts of interest that the agent may have. Good practice dictates that all reports from the agent should be reviewed on a regular basis.

Many of the UPMIFA and NYPMIFA provisions are default rules that apply if the donors and the nonprofits that they give to do not agree on specific provisions regarding how the donated funds may be spent. Accordingly, many of the statutory provisions may be made more or less onerous by express agreement of the donor and donee. Whether all of the provisions of NYPMIFA or UPMIFA applicable to a donated fund, such as diversification and documentation requirements, may be modified by such agreement remains to be resolved.

What All Nonprofits Should Do Now

All nonprofits should:

1. Generally educate their board members and investment staff on their duties under NYPMIFA/UPMIFA, especially those duties regarding:

   (a) the eight factors applicable to managing and investing any institutional fund and the eight factors (seven in states other than New York) applicable to any decision to appropriate endowment funds (and ensure that any such decisions are appropriately memorialized in contemporaneous records),

   (b) delegation of investment management, including the need to be diligent at the time of initial delegation and periodically thereafter,

(c) diversification, including the need to revisit at least once each year, and

(d) any decision to exceed the 7% rate above which an appropriation of endowments is considered presumptively imprudent (applicable only to New York-formed nonprofits and nonprofits in other states that adopted this optional provision).

2. Adopt the required investment policy or amend their existing policy to comply with the terms of NYPMIFA (applicable only to New York- formed nonprofits).

3. If they have delegated investment responsibility, review their conflicts policies to make sure financial manager conflicts at the board and officer level are addressed and, if formed in New York, include a provision in the investment policy applicable to the financial manager's selection of investments not creating any conflicts.

4. If they have existing endowment funds, give the 90-day notice to donors (applicable only to New York-formed nonprofits).

5. If they have an investment committee, review their by-laws and board resolutions to ensure that the committee is validly constituted so that it can exercise the authority of the board with respect to institutional funds.

6. If they solicit endowment funds, review and revise solicitation material to make sure that it does not limit use of funds and to ensure that endowment material has the required disclosures (applicable only to New York-chartered nonprofits).

7. If they have any gift acceptance policies and or forms of gift instruments, review such policies and forms to make sure that they override any NYPMIFA/UPMIFA default rules that the institution does not desire to be bound by.

8. If they have multiple endowment funds, make sure that their financial records properly reflect the multiple categories of funds: (a) those governed by the NYPMIFA/UPMIFA default rules, (b) those subject to any historic dollar value limitations and (c) those that are customized pursuant to gift instruments.

9. Work with their accountants to ascertain what new disclosures will be required in their financial statements and whether changes in accounting rules regarding treatment of interest and appreciation as temporarily restricted funds will create any problems under bond, loan or other covenants and, if they do, work with counterparties to have those covenants appropriately modified.

10. Work with appropriate organizations to encourage the legislature to correct errors and resolve ambiguities in the law and to relieve smaller nonprofits from some of the more burdensome provisions of the law or adopt phase-in periods.

By David W. Lowden, a Special Counsel in the Corporate and Securities Practice Group of Stroock & Stroock & Lavan LLP with a practice focused on the needs of nonprofits. For questions regarding this article or the Act, including certain provisions that could be problematic for some entities, please contact Mr. Lowden.

For More Information

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1. An institution is generally defined under the uniform version of UPMIFA as a person, other than an individual, "organized and operated exclusively for charitable purposes." NYPMIFA adds a clause that includes all corporations as defined under Section 102(a)(6) of the New York Not-for-Profit Corporation Law (N-PCL), which means all nonprofits formed in New York under the N-PCL or predecessor laws or by special act for which a corporation may be formed under the N-PCL so long as the corporation was formed exclusively for a purpose or purposes not for pecuniary profit or financial gain and no part of the assets, income or profit is distributable or enures to the benefit of its members, directors or officers except as allowed under the N-PCL.

2. UPMIFA also says that such fund must be held "exclusively for charitable purposes." Consistent with the extension of the New York Act to noncharitable institutions, such limitation does not appear in NYPMIFA.

3. UPMIFA does not say who is obligated with respect to such decisions.

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