Volume 6, No. 5

SENIOR CONSULTANT
The Voice of the Investment Management Consultant

Can Distributions Be Made from Underwater Endowments?

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Distributions from permanent endowments of public charities have been severely hard hit in recent months and in some cases, have created a shock wave to the annual budgets of these organizations. The cause of this fiscal crisis is more complicated than might be obvious.

- This has been the worst annual decline for the last 50 years. For the period 1999-2002 (since the highest values in 1999), the market, as measured by the S&P 500, has been down in excess of 45%. The only similar bear market occurred in the period 1972-74, when the S&P 500 was down by 42%. The current bear market is accompanied by a constantly increasing annual volatility (as compared to the 20-year average).
- It's not surprising that a 3-year bear market has taken its toll on the value of the endowment. According to The Chronicle of Philanthropy, the country's top 10 private foundations saw the value of their endowments drop by more than $8.3 billion in the first six months of 2002.[1] In the 12-month period beginning June 30, 2000, the value of Harvard University's endowment fell by $800 million.[2] On average, college endowments fell 3.6% in 2001, and the estimate is that the same endowments dropped another 5% in 2002.[3]
- Contributions to public charities, while still impressive, have declined dramatically during this same period of time. A survey conducted by the American Affluence Research Center in September of 2002 shows that 20% of donors planned to reduce their charitable giving.[4] In fact, 13 of the 25 largest community foundations in the country experienced a fundraising decline in 2002.[5] In a recent survey by GuideStar, almost 48% of participating charities reported a decrease in private donations in the first 10 months of 2002.[6] So, new money is hard to come by to replace the lost value of the endowment.
- Donors who are making contributions are often doing so with increasing restrictions, conditions and limitations. Unrestricted contributions to operations or programs have become more precious than ever to operating managers and financial officers who struggle to maintain a balanced budget. This means that there is less flexibility with new money to fill in the gaps created by shrinking endowments. Donor-restricted endowments (contributions which are required under the gift instrument or expressed intent of the donor to remain in perpetuity) are designed to assure the economic future of the organization through good years and bad. But it is the very nature of permanent endowments that they are the least flexible in long periods of economic hardship.
- State law, governed under the Uniform Management of Institutional Funds Act ("UMIFA") established almost 40 years ago, imposes specific guidelines under which distributions from permanent endowment may be made. For many charitable organizations, the circumstances today are the first time that they have had to really read and understand the implications of the spending restrictions imposed by UMIFA.
- Just for good measure, the Financial Accounting Standards Board, the accounting profession's industrywide panel for establishing accounting guidelines for auditors, announced measures in 1995 to protect the permanent endowment from erosion attributable to distributions.

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The Challenge

Collapsing markets, donor restrictions, governmental regulations and audit requirements have combined to put extraordinary strain on operating budgets. While CFOs and program officers understand the dilemma, it has not yet come home to the donors, many of whom will be in for an unpleasant and unwelcomed surprise. For these generous individuals, who have contributed to the financial security of their favorite institutions, they may be quite unaware that distributions to support their scholarships, endowed chairs, research projects, food and shelter programs,

and other worthy activities may be in temporary, and perhaps even long-term, jeopardy. Those who have been receiving the benefits of these endowments, including the children, students, faculty, scientists, program officers and others, may find shortly that they have no distributions coming. It is quite possibly not a short-term crisis. For some endowments, it will take years to recover.

State Law at Work

Because of the importance of UMIFA in this discussion, it's important to have some background on this little known or understood statute. In 1972, the National Conference of Commissioners on Uniform State Law drafted the Uniform Management of Institutional Funds Act (the "Uniform Act" or "UMIFA") and recommended its enactment in all states. Since then, 46 states have adopted versions of the Uniform Act.

UMIFA was intended to set standards with regards to permissible investments, delegation of investment authority and the growing interest in the total return concept. Many tax-exempt organizations were looking for ways to make more effective use of endowment funds, and there were no statutes and little case law concerning the management of such funds. Some organizations turned to the available guidance for charitable trusts, but these rules failed to address at least one crucial issue.

Public charities needed and wanted, among other things, guidance on the extent to which they could utilize contributions for their endowment's operations, programs and general purposes. At the time, many states had no guidance at all on how much of the original contributions, and any appreciation, could be distributed to its operating funds. A few states allowed charities to use as much of the realized appreciation as deemed prudent by its directors. UMIFA rejected the realized appreciation approach on grounds that its most likely effect would be the sale of a charity's best assets in order to produce spendable gains. Instead, the Uniform Act authorized the use of net appreciation.

Section 2 of the Uniform Act provides: *"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, 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 under the standard established by Section 6. This Section does not limit the authority of the governing board to expend funds as permitted under other law, the terms of the applicable gift instrument, or the charter of the institution."* [Emphasis added.]

This Section makes use of two specifically defined terms: endowment fund and historic dollar value. *Endowment fund* is defined in Section 1 of the Uniform Act as "an institutional fund, or any part thereof, not wholly expendable by the institution on a current basis under the terms of the applicable gift instrument." This term does not include "quasi-endowment" or "board restricted" funds, that is, funds that are subject to spending restrictions imposed by the organization itself, but are not subject to any similar restriction by the donor. Quasi-endowments are not limited by the spending rules of UMIFA.

BUT THE QUESTION REMAINS: HOW DO YOU CALCULATE "NET APPRECIATION," ESPECIALLY DURING TIMES LIKE TODAY, WHEN THE VALUE OF MANY ENDOWED FUNDS HAVE FALLEN BELOW THEIR HISTORIC DOLLAR VALUE?

"Historic dollar value" is also defined in Section 1, and it means *"the aggregate fair value in dollars of (i) an endowment fund at the time it became an endowment fund, (ii) each subsequent donation to the fund at the time it is made, and (iii) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the fund."* Taken together, these sections mean that a charity may use the net appreciation of the contributions to its endowment for its general purposes unless otherwise restricted by a gift instrument. But the question remains: How do you calculate "net appreciation," especially during times like today, when the value of many endowed funds have fallen below their historic dollar value?

What if the endowment's market value is below its combined historic dollar value, but some of the endowed funds are still positive — that is, their market values exceed their historic dollar value? This is certainly likely with funds that have been in the endowment for years, that have enjoyed considerable appreciation, enough so to be able to overcome the decline in the last three years. More recent funds, perhaps those that have been contributed within the last three to ten years, may not be so lucky.

The question to ponder: Can distributions be made from individual funds that still have appreciation, even if the combined endowment is below water? In other words, can ... or should … the institution look to each separate endowment fund to determine whether there is any net appreciation from which distributions can be made? Alternatively, can individual funds that are under their historic dollar value be aggregated with the older and more seasoned funds, so that the overall historic dollar value can be averaged throughout, permitting all the funds to make some distributions to operations? Viewed from this perspective, the older endowed funds can help "carry" the younger, harder hit funds.

Enter the Financial Accounting Standards Board

The American Institute of Certified Public Accountants ("AICPA") and the Financial Accounting Standards Board ("FASB") have established a set of rules and procedures on the treatment of endowments and the reporting of gains and losses to the endowment, published in a series of Financial Accounting Standards ("FAS")[7] and in the AICPA's Audit Guide for Not-for-Profit Organizations ("AAG-NPO"). These rules must be considered, in the absence of specific donor instructions or applicable state law.

For example, if a donor has required the gift to be invested in perpetuity, the fund will be considered a "donor-restricted endowment" or permanent endowment. The donor may also

have required that the earnings — gains or losses — also be restricted. If so, the net appreciation would be added to the permanent endowment. If there is no expressed condition attached to the gift or requirement under state law, it would be treated under the Audit Guide as a change to the unrestricted net assets.[8]

Under FASB 124, paragraph 12, *"in the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund shall reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before the loss occurs. Any remaining loss shall reduce unrestricted net assets."*

The footnotes to paragraph 13 of FASB 124, provide the following: *"Some donors may require that a portion of income and gains, or both. be added to the gift and invested subject to similar restrictions. It is generally understood that at least the amount of the original gift(s) and any required accumulations is not expendable, although the value of the investments purchased may occasionally fall below that amount. Future appreciation of the investments generally restores the value to the required level. In states that have enacted its provisions, the Uniform Management of Institutional Funds Act describes the 'historic dollar value' as the amount that is not expendable."*

Perhaps An Example Would Help

Assume the fair market value of the Charity's endowment is currently $10.5 million, and its combined historic dollar value is $8.5 million. Suppose that the fund is compromised of two separate gifts. The first gift came from John Generous, who contributed an asset 20 years ago with a market value of $3.5 million to the Charity's permanent endowment. Today, the Generous Fund has a value of $8.0 million, having fallen from its high of five years ago of $15.0 million. The second gift came from Mary Philanthropy, who contributed her stock at the end of 1998 (the peak of the stock bubble) when the stock was valued at $5.0 million. Today, the Philanthropy Fund has a value of $2.5 million.

The Generous Fund has a $4.5 million net appreciation. The Philanthropy Fund has a "net loss" of $2.5 million. Together, there is enough appreciation ($2.0 million) to enable Charity to make a distribution. If treated separately, however, only the Generous Fund would be entitled to make a distribution. How should the Charity handle this issue? How will it deal with its donors? How will the auditors respond?

Alternative Theories

Endowment managers and CFOs from charitable organizations have turned to accounting firms and institutional counsel for advice. Frustratingly, the advice is inconsistent and contradictory. The disagreement is over two theories, neither of which has much legislative history or case authority.

UMIFA defines "endowment fund" as an institutional fund, *or any part thereof*, not wholly expendable by the institution on a current basis. The *any part thereof* clause gives rise to the question of whether a fund refers to the total endowment, to each donor's separate contributions or some combination thereof. For

organizations without board-designated or quasi-endowment funds to cover shortfalls, this issue may become crucial.

Component Funds Theory

Under this theory, each donor's contributions constitute a separate fund and must be examined individually. The support for this theory is based on an interpretation of Comments to Subsection 5 of Section 1 of the Uniform Act, which states: *"If the gift instrument directs accumulation, the historic dollar value will increase with each accumulation. For example, if a donor gives an institution $300,000 and directs that the fund is to be accumulated until its value reaches $500,000, the historic dollar value will be the aggregate value of $500,000 at the time the fund becomes available for use by the institution.*

If under the terms of the gift instrument a portion of an endowment fund, after passage of time or upon the happening of some event, becomes currently wholly expendable, such portion should be treated as a separate fund and the historic dollar value of the remaining endowment fund should be reduced proportionately."

The Comments in Section 3 lends support to this theory. It states that each donor *"means to devote to the institution any return or benefit that the institution can obtain from [the donor's] gift, ... acknowledges the responsibility of the institutional management to determine the prudent use of the return or benefit over time,"* and *"regards the* <u>*amount*</u> *of [the donor's] gift as the dollars given or the dollar value of the property transferred to the institution at the time of [the donor's] gift."*

At least one state attorney general concurs in this approach. The New York State Attorney General's announced that New York's version of the Uniform Act, which mirrors the original act closely, requires that net appreciation be determined on a donor-by-donor basis. [9]

Aggregate Fund Theory

Under this theory, the fund must be looked at as a whole, and net appreciation is determined by considering the market value of the combined endowment over its historical dollar cost. Section 2 of the Uniform Act allows a charity to use as much of net appreciation in its endowment fund *"as is prudent under the standard established by Section 6."* Section 6 provides that, in exercising judgment under the Uniform Act, the members of the institution's governing board *"shall consider long and short term needs of the institution in carrying out its education, religious, charitable or other eleemosynary purposes, its present and anticipated financial requirements,* <u>*expected total return on its investments*</u>*, price level trends, and general economic conditions."* [Emphasis added.]

This language suggests that the institution must evaluate the overall performance of its endowment fund, not the individual components of that fund. The Comment to this Section rather cryptically states that the *"standard requires a member of a governing board to weigh the needs of today against those of the future."* This Comment makes sense only if viewed in light of the Prefatory Note, which emphasizes the wisdom of investing for *"the highest overall return consistent with the safety and preservation of the funds invested."*

THE PROPOSED SPENDING RULE ALLOWS A GOVERNING BOARD TO EXPEND SO MUCH OF AN ENDOWMENT FUND AS THE BOARD DETERMINES "TO BE PRUDENT" AND CONSISTENT WITH THE GOAL OF "CONSERVING THE PURCHASING POWER OF THE ENDOWMENT FUND"

Further Changes Ahead

In April of 2001, the National Conference of Commissioners on Uniform State Law, the body that authored UMIFA in 1972, established a Study Committee to determine whether UMIFA should be revised in light of subsequent developments — most notably the 1994 Uniform Prudent Investor Act and the 1997 Uniform Principal and Income Act. The Study Committee focused on a variety of issues, including clarifying the terms "institution" and "institutional fund" as well as the tension between UMIFA and the accounting treatment of endowed funds.

The current version of the proposed changes to the Uniform Act[10] completely eliminates the "historic dollar value" concept. The proposed spending rule allows a governing board to expend so much of an endowment fund as the board determines "to be prudent" and consistent with the goal of "conserving the purchasing power of the endowment fund." The comments concerning this new spending rule read: *"The drafting committee intends that institutions should preserve principal in endowment funds but recognizes that a total-return approach to spending makes sense for many institutions. A governing board acting prudently will not likely spend the entire endowment fund, but, depending on other facts, a governing board's decision to spend more than current income may well be prudent. For example, during an economic downturn, spending by institutions may be necessary and prudent to fulfill their purposes, even if income is limited or nonexistent .... The intent is to preserve the purchasing power of the current value of the endowment fund. 1972 UMIFA, with it use of historic dollar value, does not do that."*

Despite this notable change in viewpoint, the current proposed revision does not clearly address the issues raised in this article, specifically whether each donor's gift must be considered separately, or may be considered together with all similarly situated donors. The language remains ambiguous and allows for multiple interpretations. The definitions still define the "endowment fund" as an "institutional fund, or any part thereof, not wholly expendable by the institution on a current basis." This could be considered a single gift by a single donor, or the collection of all the gifts by the combined donors. Revised Section 3 refers specifically to "the intent of the *donors* of the endowment fund," and revised Section 4 refers to "the expected return from income and the appreciation of [the organization's] investments," both seem to support the Aggregate Fund Theory.

Enter Donor Relations

Lost in the debate is the impact on donor relations and fund raising efforts. Donors have the right to be upset. Expectations will not be met, and programs and projects will be severely impacted at best. Contributions designed to support an endowed chair may not be able to make any distributions for months or perhaps years. Scholarships will be curtailed or terminated. Research support will be reduced, and some of the initiatives will cease.

Some institutions, with large discretionary endowments, may forestall the adverse consequences for their donor constituents by filling in the gap. But this will draw support from other institutional requirements and create strong competing demands within the institution. Other institutions may not be as fortunate. They will have to approach their donors, at least those still living and competent, to clarify their intent or obtain their approval for a variance from the UMIFA restrictions. Fund raising is difficult enough without having to explain how the collapse in the endowment has impacted the donor's personal contributions. Nonetheless, this is a step that may be required — or even preferred. Even if the donor's funds have not yet been impacted, the future is uncertain enough. Changes can be made with donor's consent. Without a living and competent donor, such changes may become impossible. Courts will certainly be reluctant to disturb the status quo or the perceived donor intent.

Community Foundations have their own rules The current version of UMIFA does not apply to a community fund that is organized as a trust.[11] The Accounting Practices Committee of the Community Foundations Fiscal and Administrative Officers Group concluded that traditional donor-restricted fund rules of FAS 116, 117 and 124 do not apply to most donor-advised funds and have treated these funds as unrestricted. This conclusion seems supported by the Deputy General Counsel of the Council on Foundations in a recent release to community foundation members of the Council.[12]

Final Thoughts

With a paucity of legislative or judicial authority, it is reasonable for the governing board of the charitable organization to make a decision on which theory it intends to follow. Perhaps the consent of the auditors and, where possible, the concurrence of the donors, the governing board should determine its policy and adhere to it consistently and continuously. This is not an action that can or should be modified as the economic circumstances change. Donors and the public are entitled to some degree of certainty.

There is no "right answer." Each theory has its merits. The Aggregate Fund Theory allows an institution to better plan for inflation's erosive impact on purchasing power and for the effect of investment and administrative costs. It is certainly administratively easier to operate and enables the investment managers to focus on the combined assets of the endowment, rather than each specific donor fund. If the investment decisions were made on the risk and return of each separate fund, management could become impractical, if not impossible.

Both the current version of the Uniform Act and the proposed revision allow a donor to give specific instructions regarding distributions from the contribution

The Component Funds Theory, on the other hand, enables the older funds with more built-up appreciation to continue their distributions without having to share such appreciation with newer and less mature funds. After all, they are entitled to enjoy the benefits of the time value of their contributions, while younger funds may have to suffer the risk of short-term market volatility.

Absent clear authority, it may be possible for the institution to establish and publish its own interpretation and policy, which must then be applied consistently and continuously. It seems obvious that the development team at each institution should be more proactive in dealing with this issue. Both the current version of the Uniform Act and the proposed revision allow a donor to give specific instructions regarding distributions from the contribution. Gift agreements should specify how appreciation should be determined; whether distributions from principal may be made, and under what conditions; whether the assets should be merged into the overall endowment and blended into the distribution rate from the overall endowment; and whether distributions can be made for a period of time irrespective of investment performance.

Fund raising in difficult economic times is challenging enough. Donors want more control over and comfort in their contributions. So, restricted permanent endowment will likely continue to grow. But, in conditions like the present, our charitable institutions are under enormous financial pressures, as they struggle with reduced contributions and declining earned revenues. The uncertainty is unfair to donors and threatening to the very survival of our charities. Under the current environment, endowment distributions have become as hard to predict as the stock market itself. It's time to bring resolution to this issue. ■

Notes

1. "The Tide Turns," *The Chronicle of Philanthropy,* www.philanthropy.com, October 31, 2002.
2. Powell, Alvin. *Harvard Endowment Beats Benchmark, Value Declines,* www.news.harvard.edu, September 27, 2001.
3. "The Tide Turns," above.
4. Id.
5. Id.
6. *Charitable Organizations and the Economy,* GuideStar, www.guidestar.org, November 26, 2002.
7. Statement of Financial Accounting Standards No. 116, No. 117, No. 124.
8. AAG-NPO, Sec. 8.15, revised July 22, 2002.
9. Released February 14, 2002; revised October 2002. See web site at www.oag.state.ny.us/charities.
10. Released December 13, 2002.
11. Four states (Hawaii, Indiana, North Carolina, West Virginia) have modified the Uniform Act to apply to their community foundations operating in trust form. A few

states (e.g., Florida and Alabama) specifically limited UMIFA to educational institutions, so the statute does not apply to their corporate form community foundations.

12. Memorandum from Janne Gallagher, Deputy General Counsel, dated April 3, 2002.

About the Authors

IFF Advisors, LLC is a national consulting firm created to enhance the human, intellectual, social and financial capitals of individual, family, foundation and non-profit clients, through independent, impartial fee-based advice. IFF Advisors operates through its four divisions: Institute for Family Foundations, Institute for Family Enterprise, Institute for Corporate Philanthropy and Institute for Non-Profit Management. Visit their web site at www.IFFAdvisors.com for more information or call 949-833-1112.

Notes

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