

September 27, 2010

**QUESTIONS ARISING FROM ENACTMENT OF THE NEW YORK PRUDENT
MANAGEMENT OF INSTITUTIONAL FUNDS ACT ("NYPMIFA")**

I. Definition of "Institution"

- A. Section 551 of NYPMIFA defines an "institution" as (1) a person, other than an individual, organized and operated exclusively for charitable purposes; (2) a trust that had both charitable and non-charitable interests, after all non-charitable interests have terminated; or (3) any corporation described in subparagraph five of paragraph (a) of section 102 (definitions) of the N-PCL. Section 102(a)(5) of the N-PCL defines "corporation" as "a corporation (1) formed under this chapter, or existing on its effective date and theretofore formed under any other general statute or by any special act of this state, exclusively for a purpose or purposes not for pecuniary profit or financial gain, for which a corporation may be formed under this chapter, and (2) no part of the assets, income or profit of which is distributable to, or inures to the benefit of, its members, directors or officers except to the extent permitted under this statute." Section 201 of the N-PCL allows for formation of Type A, C, and D corporations, which in general, are not charitable (e.g., those formed for non-pecuniary civic, social, or fraternal purposes).

Question: Does NYPMIFA apply to Type A, C, and D corporations (which may be exempt from tax under IRC Section 501(c)(4) and not 501(c)(3))?

Answer: We believe that NYPMIFA applies to all corporations incorporated under the N-PCL, including Type A, B, C and D corporations.

Question: Does NYPMIFA apply to institutions operating in New York but incorporated under the laws of another state?

Answer: We believe that an institution not formed under the laws of New York State will not be subject to NYPMIFA because of the internal affairs doctrine. Instead, we believe a court would apply the version of UPMIFA enacted in the institution's state of formation.

- B. The term "institution" includes a trust that had both charitable and non-charitable interests, after all non-charitable interests have terminated. The term "institutional fund" is defined as a fund held by an institution, but does not include a fund held for an institution by a trustee that is not an institution. It is our understanding that UPMIFA¹ is intended to apply to only those trusts where the trustee of the trust is a charity. The NCCUSL² commentary to the definition of "institution" states: "the term institution includes a trust organized and operated exclusively for charitable purposes, but only if a charity acts as trustee. This approach leaves unchanged the coverage of UMIFA."³

¹ Uniform Prudent Management of Institutional Funds Act.

² National Conference of Commissioners on Uniform State Laws.

³ Uniform Management of Institutional Funds Act.

Question: If a bank is the trustee for a charitable remainder trust ("CRT"), and the non-charitable interests have terminated, does NYPMIFA govern the funds held by the CRT?

Answer: We believe that NYPMIFA does not govern the funds held by a CRT where the trustee is a bank.

Question: After the funds are paid out by the CRT to the charitable remainderman, are the funds governed by NYPMIFA?

Answer: We believe that, after the funds are paid out by the CRT to the charitable remainderman, the funds are governed by NYPMIFA if the charitable remainderman is an institution formed under the laws of New York State.

II. Standard of Conduct in Managing and Investing an Institutional Fund

- A. NYPMIFA requires that those responsible for managing an institutional fund act "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." NYPMIFA also requires consideration of the following factors in managing and investing an institutional fund (i) general economic conditions; (ii) the possible effect of inflation or deflation; (iii) the expected tax consequences, if any, of investment decisions or strategies; (iv) the role that each investment or course of action plays within the overall investment portfolio of the fund; (v) the expected total return from income and the appreciation of investments; (vi) other resources of the institution; (vii) the needs of the institution and the fund to make distributions and to preserve capital; and (viii) an asset's special relationship or special value, if any, to the charitable purposes of the institution.

Question: Is the Board required to record its consideration of each of the factors in managing and investing an institutional fund?

Answer: NYPMIFA does not explicitly require an institution to keep a contemporaneous record describing the consideration that was given to each factor. However, we believe that it would be appropriate for an institution to record that these factors were considered.

- B. Except as otherwise provided in a gift instrument, NYPMIFA provides that an institution must diversify the investments of an institutional fund unless the institution prudently determines that, because of special circumstances, the purposes of the fund are better served without diversification.

Question: Under section 552 of NYPMIFA, may a donor restrict the manner in which an institution invests an endowment fund? For example, may a Board prudently determine to accept a gift where the gift instrument requires the gift funds to be invested in an investment fund managed by the donor?

Answer: We understand that commentators have questioned whether courts will enforce a direction not to diversify in the trust context.⁴ Therefore, we question whether the courts would enforce this provision.

Question: May a Board prudently determine to accept a gift where the gift instrument requires the gift funds to be invested solely in Treasury bonds?

Answer: We understand that commentators have questioned whether courts will enforce a direction not to diversify. Therefore, we question whether the courts would enforce this provision, and we believe that the result could vary with the financial climate at the time the case might be brought. We believe it more likely that a court would uphold a provision requiring investment in Treasuries than the provision requiring investment in a fund managed by a donor, but institutions need guidance on how the New York Attorney General expects institutions to assess these types of restrictions.

III. Appropriation for Expenditure

- A. UPMIFA requires that an institution consider seven prudent management criteria in deciding whether to appropriate or accumulate endowment funds. An additional factor was included in section 553 of NYPMIFA: that the institution, “where appropriate and circumstances would otherwise warrant,” consider “alternatives to expenditure of the endowment fund, giving due consideration to the effect that such alternatives may have on the institution.”

Question: What steps should an institution take to comply with this additional factor?

Answer: Absent guidance from the Attorney General, we believe that, where appropriate and circumstances would otherwise warrant, an institution should record in its minutes any alternatives to expenditure that were considered.

- B. NYPMIFA requires that an institution keep a contemporaneous record describing the consideration given by the governing board to each of the factors enumerated in section 553.

Question: Is the record-keeping requirement met through a description in the minutes of the consideration given by the governing board (or committee) to each factor?

Answer: We believe that this description in the minutes would meet the record-keeping requirement.

Question: Must the governing board (or committee) consider each factor, and document its consideration, on a fund-by-fund basis, or may a decision be made and documented to appropriate from multiple similarly-situated endowment funds simultaneously (e.g., by application of a specific spending rate to many funds)?

Answer: We believe that the governing board may appropriate from multiple similarly-situated endowment funds simultaneously (e.g., by application of a specific spending rate).

⁴ See John H. Langbein, *Burn the Rembrandt? Trust Law's Limit on the Settlor's Power to Direct Investments*, 90 B.U.L. Rev. 375 (2010).

Question: If an institution may make one decision to appropriate from multiple endowment funds, how should this be documented?

Answer: We believe that the governing board (or a committee) may describe, in the minutes of its meeting, the consideration given to each of the factors enumerated in section 553 in determining the spending rate to be applied to multiple endowment funds and need not repeat the factors for each separate fund.

- C. Section 553 of NYPMIFA states that expenditure in any year of greater than 7% of the fair market value of an endowment fund, calculated on the basis of market values determined at least quarterly and averaged over a period of not less than five years immediately preceding the year of appropriation, creates a rebuttable presumption of imprudence. The comments to UPMIFA state that the presumption may be rebutted by the institution if circumstances in a particular year make expenditures above that amount prudent. In addition, the comments to UPMIFA state "If sufficient evidence establishes, by the preponderance of the evidence, the facts necessary to raise the presumption of imprudence, then the institution will have to carry the burden of production of (i.e., the burden of going forward with) other evidence that would tend to demonstrate that its decision was prudent. The existence of the presumption does not shift the burden of persuasion to the charity."

Question: How may an institution meet the burden of production to demonstrate that it has prudently appropriated in excess of 7%?

Answer: We believe the Board may document in the minutes its decision-making process.

Question: Does the 7% presumption apply to funds that are not underwater, such that the presumption of imprudence would apply to appropriation solely of income and appreciation?

Answer: We believe that the 7% presumption applies to endowment funds whether or not underwater and would apply to an appropriation solely of income and appreciation.

- D. The effective date of NYPMIFA is the date of enactment.

Question: If a decision to appropriate is made prior to enactment of NYPMIFA, but the appropriated funds are expended after enactment of NYPMIFA, is the decision to appropriate subject to the standards of NYPMIFA or prior law? For example, if a decision to appropriate was made in June, 2010, for the 2011 fiscal year, is the decision evaluated in light of NYPMIFA or prior law?

Answer: We believe that if a decision to appropriate is made prior to enactment of NYPMIFA, then prior law should be applied to that decision, regardless of when the funds are expended. For example, if a decision to appropriate was made in June 2010, then prior law applied, and the institution is not required to reevaluate the decision in light of NYPMIFA at the time such funds are expended.

IV. Appropriation and Notice

- A. Under section 553 of NYPMIFA, with respect to a gift instrument executed by the donor before the effective date of NYPMIFA, an institution must provide 90 days advance notice to the donor, if available, before appropriating from the applicable endowment fund for the first time.

Question: Does the 90-day notice requirement prevent any appropriation from a previously existing fund for a period of 90 days after NYPMIFA is passed? That is, does the notice requirement apply to the first instance of any appropriation from an endowment fund after enactment of NYPMIFA, including appropriation of solely income and appreciation, or does it only apply prior to the first instance of an appropriation where the institution is invading original dollar value?

Answer: We believe that notice should be required only prior to the first instance of the institution invading original dollar value. Stated differently, we believe that an institution should be able to prudently appropriate from its endowment during the 90 days after enactment, so long as it does not invade original dollar value. If an institution is not allowed to appropriate for 90 days, many New York institutions are likely to experience cash-flow crises and will be looking for relief from the Attorney General. While we are advising clients to give notice ASAP to start the 90-day period and receive and categorize funds by donor response, we believe that institutions should be permitted to appropriate but not invade during the 90-day period.

- B. Section 553 specifies that notification should be substantially in the form of boxes that the donor may check providing either that (i) the institution may spend as much of the endowment gift as is prudent under NYPMIFA's standards, or (ii) the institution may spend in accordance with NYPMIFA's prudence standard but may not spend below the original dollar value of the gift. NYPMIFA includes a sample explanation for donors, stating "If you check box #1 above, the institution may spend as much of your endowment gift (including all or part of the original value of your gift) as may be prudent under the criteria set forth in article 5-A of the N-PCL. If you check box #2 above, the institution may not spend below the original dollar value of your endowment gift, but may spend the income and the appreciation over the original dollar value of it is prudent to do so. The criteria for the expenditure of endowment funds set forth in Article 5-A of the N-PCL will not apply to your gift."

Question: If a donor has checked box #2, does the prudence standard set forth in NYPMIFA apply to appropriation of income and appreciation from the endowment funds established by the donor? If not, what prudence standard does apply to appropriations of income and appreciation from these endowment funds?

Answer: We believe that if a donor has checked box #2, then the prudence standard set forth in NYPMIFA should apply to the decision to appropriate. However, the institution may only appropriate income and appreciation and may not invade original dollar value.

Question: Does the donor's choice of box #1 or box #2 affect the application of the 7% rebuttable presumption of imprudence?

Answer: No, in either case, the 7% presumption or imprudence would not apply. The 7% presumption only applies to gift instruments executed on or after the effective date of NYPMIFA, while the notification provision of 553(e)(1) (and donor's ability to thereby prohibit an institution from invading original dollar value) applies only to gift instruments executed before the effective date of NYPMIFA.

Question: Does an institution run the risk of inappropriate practice of law if the donor asks the institution for explanation of NYPMIFA?

Answer: We believe that institutions should inform donors of the law in a manner substantially similar to that set forth in NYPMIFA and should recommend that donors ask any additional technical questions of their personal counsel.

V. Delegation of Management and Investment

- A. Section 554 of NYPMIFA states that an institution may delegate to an external agent the management and investment of an institutional fund to the extent that the institution could prudently delegate under the circumstances. The institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances in (1) selecting, continuing or terminating an agent, including assessing the agent's independence including any conflicts of interest such agent has or may have; (2) establishing the scope and terms of the delegation, including the payment of compensation, consistent with the purposes of the institution and the institutional fund; and (3) monitoring the agent's performance and compliance with the scope and terms of the delegation.

Question: What steps should an institution take in selecting, continuing or terminating an agent, including assessing the agent's independence, including any conflicts of interest such agent has or may have?

Answer: We believe the institution should request and review information regarding the agent's experience, personnel, track record and proposed compensation as compared to appropriate peers and do other customary due diligence as required. In addition, the institution should have a conflict of interest policy and follow the policy in selecting the agent. This would generally require that the institution determine if any of its officers or directors are officers or directors of or have a substantial financial interest in the agent. If so, the material facts as to the director's or officer's interest should be disclosed to the governing board (or committee) and such person should abstain from the vote to select or terminate the agent. See section 715 of the N-PCL.

Question: What steps should an institution take to establish the scope and terms of the delegation, including the payment of compensation, consistent with the purposes of the institution and the institutional fund?

Answer: We believe that the governing board (or committee) should enter into a written agreement with the agent, setting forth the scope and terms (including terms of compensation) of the engagement.

Question: What steps should an institution take to monitor an agent's performance and compliance with the scope and terms of the delegation.

Answer: We believe that the governing board (or committee) should receive and review regular reports on the agent's performance.

Question: Can the governing board delegate to a committee of the board or an external agent the authority to appropriate from an endowment fund?

Answer: Section 712 of the N-PCL states that the governing board may designate committees, each of which may have all of the authority of the board, except for certain prohibited activities listed in the N-PCL. Appropriation from an endowment fund is not one of the listed prohibited activities. Therefore, we believe that the governing board may delegate the authority to appropriate from an endowment fund to a committee. NYPMIFA does not specifically discuss delegation of the authority to appropriate from an endowment fund to an external agent. Section 551(d) of NYPMIFA states that the obligations of NYPMIFA are imposed on the governing board. Therefore, we believe that the authority to appropriate from an endowment fund is a core board function that may be delegated to a board committee but should not be delegated to an external agent.

- B. NYPMIFA specifies in the definition of "institution" in section 551 that the governing board retains responsibility for compliance with the provisions of NYPMIFA. Section 554 of NYPMIFA states that an institution that complies with the requirements for prudent delegation to an agent is not liable for the decisions or actions of an agent to which the function was delegated.

Question: Does NYPMIFA change prior law that appropriate delegation relieves the Board of liability for acts or omissions of those to whom such responsibilities are delegated?

Answer: We believe that NYPMIFA does not change prior law.

VI. Release and Modification of Restrictions

- A. Section 555 of NYPMIFA states that if an institution determines that a restriction on the management, investment or purpose of an institutional fund is unlawful, impracticable, impossible to achieve or wasteful, after 90 days notice to the Attorney General and the donor (if the donor is available), the institution may release or modify a restriction contained in a gift instrument if (1) the fund has a total value of less than \$100,000; (2) more than 20 years have elapsed since the fund was established; and (3) the institution uses the property in a manner consistent with the purposes expressed in the gift instrument.

Question: Does the term "property" mean any asset (including cash and securities) held in the applicable endowment fund?

Answer: We believe that the term property includes any asset (including cash and securities) held in the applicable endowment fund.

Question: In what ways, if any, has donor standing has changed with the enactment of NYPMIFA?

Answer: We believe donor standing has not changed with the enactment of NYPMIFA.