SIMPSON THACHER

CLIENT MEMORANDUM

Spending by New York Not-for-Profit Corporations From "Underwater" Endowment Funds

February 9, 2009

This memorandum summarizes possible restrictions on spending by a New York not-for-profit corporation or education corporation (a "Not-for-Profit Corporation") from an "endowment fund" if the fair market value of the fund is less than its "historic dollar value" (an "Underwater Fund").

The spending of endowment funds by a Not-for-Profit Corporation is currently governed by the Uniform Management of Institutional Funds Act ("UMIFA"), as enacted in 1978 in the New York Not-for-Profit Corporation Law (the "N-PCL"). An "endowment fund" is a fund which a donor designates in a written gift instrument to be not wholly expendable by the Not-for-Profit Corporation on a current basis.[1] As a result of this law, the Not-for-Profit Corporation is required to preserve the "historic dollar value," or principal, of an endowment fund unless the donor provides otherwise as described below.

The "historic dollar value" of an endowment fund is the aggregate fair market value of all gifts made by donors into that particular fund. A common way in which donors may override the general rule requiring preservation of historic dollar value is by specifying in their written gift instruments that the Not-for-Profit Corporation's spending-rate policy be applied to the funds. A "spending-rate policy" is a policy adopted by the governing board of a Not-for-Profit Corporation that specifies the percentage to be appropriated for spending in that year.

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[1] N-PCL Section 102(a)(13). In contrast, any fund which cannot be spent on a current basis because the Not-for-Profit Corporation's governing board, rather than a donor, has restricted spending is not an endowment fund but rather a "Board-restricted fund." Because the governing board can vote at any time to lift the restrictions on a "Board-restricted fund," they are treated for accounting purposes as "unrestricted." These types of funds are not subject to the rules discussed in this memorandum.

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I. SPENDING WHEN A FUND IS UNDERWATER

In the publication entitled "*Advice for Not-For-Profit Corporations on the Appropriation of Endowment Fund Appreciation*" (the "Endowment Fund Advice"),[2] the New York State Attorney General has stated that when a fund is underwater, a Not-for-Profit Corporation may continue to spend the income earned on the fund. For this purpose "income" means dividends, interest, rents and royalties. However, the New York State Attorney General does not approve of spending any net appreciation from an Underwater Fund unless the net appreciation was appropriated for spending by the governing board before the fund became an Underwater Fund.[3]

II. DUTY TO RESTORE WHEN FUND IS UNDERWATER DUE TO APPLICATION OF THE NOT-FOR-PROFIT CORPORATION'S SPENDING-RATE POLICY

Most Not-for-Profit Corporations use a spending-rate policy to determine the amount that will be spent annually from their endowment funds.

In the Endowment Fund Advice, the New York State Attorney General has taken the position that a Not-for-Profit Corporation's governing board has an affirmative duty to restore the historic dollar value of a fund that becomes an Underwater Fund as a result of the Not-for-Profit Corporation's application of its spending-rate policy. The New York State Attorney General does not prescribe in the Endowment Fund Advice how the restoration should occur. Therefore, we believe that the Not-for-Profit Corporation's governing board may consider a number of options, including the following:

- If an Underwater Fund generates income, do not appropriate the income for spending but instead "spend" (i.e., use) the income to restore the Fund's historic dollar value.
- Appropriate the necessary amount from unrestricted funds to restore an Underwater Fund's historic dollar value, as necessary; this may be done pursuant to a resolution whereby the unrestricted funds may be reappropriated (i.e., redesignated as unrestricted) when the Fund's fair market value appreciates to historic dollar value.
- For an existing endowment fund, contact the donor(s) who contributed to the Underwater Fund and request that the donor(s) consent in writing to the governing board applying its spending-rate policy to the Fund, even if doing so will cause the fund balance to fall below historic dollar value.
- For a new endowment fund, include a provision in the gift instrument to permit the governing board to apply its spending-rate policy to the fund, even if doing so will cause the fund balance to fall below historic dollar value.

III. SPENDING WHEN FUND IS UNDERWATER DUE TO MARKET DEPRECIATION

In contrast to the position described above, the New York State Attorney General has not formally taken the position in the Endowment Fund Advice that the Not-for-Profit Corporation's governing board has an affirmative duty to restore the balance of any Underwater Fund that is below its historic dollar value solely due to market depreciation. However, until the fund grows back to its historic dollar value, the governing board may not spend currently any amounts other than interest, dividends, rents and royalties allocable to each fund. This means that the Not-for-Profit Corporation may not apply in full its approved spending-rate policy if its application would result in appropriation and spending of more than the income allocable to the fund, calculated on a fund-by fund basis.

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[2] A copy of the Endowment Fund Advice can be obtained from the New York State Attorney General's website at http://www.oag.state.ny.us/bureaus/charities/pdfs/endowment.pdf.

[3] The N-PCL allows governing boards to appropriate for spending as much of the net appreciation, realized (with respect to all assets) and unrealized (with respect only to readily marketable assets), as is prudent under the law.

IV. REPLACEMENT OF UMIFA WITH UPMIFA

As noted above, a Not-for-Profit Corporation's spending of Underwater Funds is currently governed by UMIFA, as incorporated into the N-PCL. We are assisting New York's Commission on Independent Colleges and Universities (cIcu) in drafting legislation to incorporate the Uniform Prudent Management of Institutional Funds Act ("UPMIFA") into the N-PCL in lieu of the current UMIFA provisions. Under the UPMIFA proposal, the Not-for-Profit Corporation would no longer be required to hold the historic dollar value of an endowment fund intact, unless the donor specifically required the Not-for-Profit Corporation to do so in a gift instrument. Instead, the Not-for-Profit Corporation would be permitted to apply a prudent spending-rate to appropriate and spend so much of an endowment fund as the Not-for-Profit Corporation deemed prudent for the uses, benefits, purposes and duration for which the endowment fund was established.

We believe that the enactment of UPMIFA in New York State and the elimination of historic dollar value as the default rule would be a positive development for Not-for-Profit Corporations. We note that UPMIFA would apply to both Not-for-Profit Corporations and trusts, thereby harmonizing their spending planning. According to www.UPMIFA.org, UPMIFA has been enacted in twenty-six states and the District of Columbia and is pending in nine other states. We believe that enactment of UPMIFA in New York State would be an important way in which the New York State Legislature and Governor could readily assist cash-strapped Not-for-Profit Corporations and trusts at no cost to the State.

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