# PRINCIPLES OF ENDOWMENT ADMINISTRATION

***prepared by***
***Institutional Advancement***
***UC Office of the President***

A **true endowment** is created by a gift or bequest when a donor instructs the fiduciary that the corpus of the gift be held in perpetuity (or for a specified term of years) with the income/payout used to support the institution or a particular program. Even absent a statement about holding the corpus in perpetuity, the intent to create an endowment should be inferred if the donor instructs that the *income* be used to support the institution or a particular program. Such gifts may be held in a fiduciary capacity by The Regents, a Campus Foundation, or an independent trustee licensed to engage in trust business.

When a gift is given to the University, it is not considered legally consummated until the University agrees to the conditions and notifies the donor of acceptance of the gift. If a gift or bequest is received without disclaimer by the University or the Campus Foundation, the University assumes the legal obligation to administer the gift or bequest in a manner consistent with the terms specified by the donor. This obligation arises under an area of the law known as the law of charitable trusts, and is subject to enforcement on behalf of the public by the Attorney General of California.

A **fund functioning as an endowment**, also called a **quasi-endowment**, may be created by a gift or bequest when a donor does not instruct either that the gift be expended in its entirety or held as a true endowment. In such cases, the institution may, acting in its own discretion, decide to create a fund functioning as an endowment or quasi-endowment, which means the funds are invested in the same manner as if they were subject to the terms of a true endowment, with the crucial distinction that the institution may at any time decide to withdraw all or part of the corpus of the fund and expend it for the purpose designated by the donor.

California trust law (Probate Code Section 15000 et seq) provides among other things:

- The fiduciary must **invest the corpus prudently** in accordance with the Uniform Prudent Investor Act (Probate Code Section 16045 et seq).

The **income/payout must be expended strictly in accordance with the donor's instruction**. Expenditures for purposes other than those set forth in the terms of the gift or as subsequently modified with the donor are unlawful and are not to be permitted. The institution and individuals willfully engaged in expenditures for impermissible purposes may be subject to civil and criminal penalties. If changed circumstances make expenditure of the funds in accordance with the terms of the gift unlawful, impracticable, impossible to achieve, or wasteful, and if the donor is not able to agree to the proposed change in the terms, then the institution should seek the advice of the California Attorney General and subsequently, under the *cy pres* doctrine, apply to a Court of appropriate jurisdiction to seek approval of the proposed change. Institutional Advancement and the Office of the General Counsel will assist the campus in a review of an endowment fund's terms and the steps to be taken for proposals to the Attorney General.

- **Excessive accumulation of income/payout must be avoided**. The General Counsel of The Regents recommends that the income/payout be expended regularly. As a guiding principle, the income/payout accumulation should not be allowed to exceed five years.

- In the case of a true endowment, the unjustified failure to expend income/payout as it is earned may constitute a **breach of fiduciary duty** under trust law. Accumulation may be justified if it is 1) not inconsistent with the terms of the gift, and 2) being done for a specific purpose consistent with the terms of the gift, such as equipment purchase. Simply deciding not to spend the funds without a specific purpose, or that the funding may likely be more useful at a later date, is not justification for not carrying out the donor's instruction. Accumulation is justified if it is agreed to in writing by the donor and the institution.

**Conditions under which endowment income/payout may be added to endowment principal:**

- Endowment income/payout must be spent strictly in accordance with the donor's instruction. There may be times, however, when, due to a variety of circumstances, such expenditure is not possible. In these situations, Institutional Advancement and the Office of the General Counsel, Office of the President, will assist the campus in a review of an endowment fund's terms. In addition, assistance will be provided when the literal construction of the fund's terms is unlawful, impracticable, impossible to achieve, or wasteful, which may require court approval of revised terms.

- Requests to the administration to add accumulated income/payout to principal will be permitted when the donor has expressly requested that it be done. Such requests may also be permitted when the donor's terms establish an endowment for a specific purpose that requires greater annual income/payout than is currently being produced by the endowment corpus, but which, with the addition of accumulated income/payout, would eventually produce an adequate income/payout stream to support the fund's stated purpose.

**Campus responsibility for administration of endowed funds:**

A campus has the fiduciary responsibility for the appropriate and timely expenditure of the payout from endowed funds and funds functioning as endowments held by both The Regents and the Campus Foundation. Procedures shall be developed in the campus budget process to incorporate into campus and department budgets the endowment payout distributed annually by The Regents and available annually for distribution from the Campus Foundation for expenditure each fiscal year.

**Endowment-related terms defined by Webster's Dictionary, Black's Law Dictionary, and others:**

**allocation:** the administrative designation of fund terms that have not been specified by a donor, such as the location at which the funds will be used, the type of fund (endowment, fund functioning as an endowment, current fund), and the purpose for which the funds will be used.

**bequest:** a gift by will of personal property {real property can also be received via a bequest although this is sometimes referred to as a devise}; a legacy. A bequest can be "specific" (designating a particular dollar amount or a specific asset(s)), or it can be a "residual" bequest (a percentage of the residue after payment of other expenses and obligations).

**book value:** the value in dollars at the time the fund was endowed.

**carrying value:** the amount at which securities or equities are reported in the financial statements.

**corpus:** the main body or corporeal substance of a thing; specifically, the principal of a fund or estate as distinct from income or interest.

***cy pres*:** a rule providing for the interpretation of instruments in equity as nearly as possible in conformity to the intention of the testator (donor) when literal construction is illegal, impracticable, or impossible -- called also *cy pres doctrine*.

**earnings:** the sum of stock dividends, bond interest, cash equivalent interest, rents, royalties, and other net cash flows earned by assets held by an endowment over a specified period of time. It does not include principal appreciation, or realized gains or losses.

**endowment:** the act of settling a fund, or permanent pecuniary provision, for the maintenance of a public institution, charity, college, etc. The fund settled upon a public institution, etc., for its maintenance and use.

An endowment is a fund held in perpetuity at the instruction of the donor or another, the income/payout from which supports specific or general University programming.

**fair value:** the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Commonly referred to, and defined in the Internal Revenue Code, as "fair market value".

**fiduciary:** of, or relating to, involving a confidence or trust; held or founded in trust or confidence; depending on public confidence for value or currency; also, the agent or person who holds the trust.

**gift:** something voluntarily transferred by one person to another without compensation.

**historic value:** the aggregate value in dollars at the time the fund was endowed, each subsequent donation to the fund at the time it was made, and each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation was added to the fund. The total value of all gifts to a fund, not including any appreciation.

**income:** a gain or recurrent benefit usually measured in money that derives from capital or labor; *also*: the amount of such gain received in a period of time. Absent any qualifying language, income refers only to "ordinary income" or "trust accounting income" which would not include any capital gains - whether realized or not. However, income can also be defined to include certain realized capital gains (some net income charitable remainder trusts have this provision). In practice, this term may be used to refer to the "payout" from an endowment with a *total return expenditure policy* (see below).

**investment:** the outlay of money so that it may produce a revenue or income.

**market value:** with the implementation of GASB 31, the term *market value* has been replaced by the term *fair value* for financial reporting purposes. Commonly referred to as fair market value.

**payout:** the amount approved for distribution and current expenditure from the corpus of an endowment. See UPMIFA and *total return policy.*

**Prudent Investor Rule:** California Probate Code Article 2.5 (Sections 16045-16054) describes 1) a trustee's duty to the beneficiaries of a trust; 2) the standard of care, portfolio strategy and return objectives in management of the trust; and 3) other points regarding investment and the costs of management. This rule is the legal justification for the practice of maintaining a diversified investment portfolio.

**reallocation:** the administrative redesignation of fund terms that have not been specified by a donor, such as the location at which the funds will be used, the type of fund (endowment, fund functioning as an endowment, current fund), and the purpose for which the funds will be used.

**total return expenditure policy**: endowment expenditure plans permitted to an institution that has adopted UMIFA or UPMIFA (see below), as has been done by the Campus Foundations and most colleges and universities in the United States. An institution may take a number of different approaches to setting its total return expenditure policy. For example, the total return expenditure policy that is probably the most frequently occurring provides that the endowment make available for expenditure an amount equal to five percent of a five-year moving average of the value of the endowment. This practice permits the institution to inform donors at the time of the gift what percentage of his or her donation will be available in future years.

**UMIFA**: Uniform Management of Institutional Funds Act, California Probate Code Section 18500 et seq., was superseded in California in January 2009 by the Uniform Prudent Management of Institutional Funds Act (UPMIFA), California law governing the management, investment and spending of donor–created endowment funds held by charitable organizations (see UPMIFA below). Until January 1, 2009, endowment funds were regulated by the UMIFA. UPMIFA applies to all donor–created endowment funds held by charitable institutions in California.

UMIFA originally promulgated nationally to apply to all educational, religious, charitable, and eleemosynary institutions and to governmental organizations that hold funds for such purposes. The legislation prescribes the specific investment authority, the authority of governing boards to delegate day-to-day investment management, the standards of care and prudence in the operation of a non-profit institution, and the release of donor-specified restrictions on the use or investment of endowed gifts under certain circumstances. California originally enacted the UMIFA in 1973; it was the only state prior to 1990 among the 30 that passed UMIFA to restrict the legislation to certain accredited private schools and colleges. The revised UMIFA, supported by the University of California and passed by the California State Legislature in 1990, broadened the scope of the Act to apply to any incorporated or unincorporated organization administered and operated exclusively for educational, religious, charitable, or other eleemosynary purposes, or governmental organizations, to the extent that they hold funds exclusively for any of those purposes.

UMIFA permitted a change in the traditional rule that trustees of trusts, including endowments, could spend only current income. In January 1991, California's revised version of UMIFA became effective, allowing trustees of both private and public charitable institutions to spend, in addition to current income, a portion of the net realized or unrealized appreciation in the value of the assets in the trust. The trust's income, plus the realized or unrealized gain, produces the "total return" of the trust. An institution that adopted UMIFA was permitted, but not required, to adopt a *total return expenditure policy*. However, without first adopting UMIFA, an institution must continue to adhere to the income only expenditure policy; the other provisions of UMIFA applied uniformly to charitable organizations without requiring an act by the governing board.

**UPMIFA**: Uniform Prudent Management of Institutional Funds Act, California Probate Code Section 18500 et seq., In 2008, California adopted the Uniform Prudent Management of Institutional Funds Act ("UPMIFA") effective as of January 2009. This Act modified the prior Uniform Management of Institutional Funds Act (UMIFA) that had been in place since 1972 – though it had not applied to UC and to UC Campus Foundations until 1990. UPMIFA was enacted to update the prudence standard and to provide flexibility in the management of endowment funds in market downturns and when modifying restrictions on endowment funds due to changed circumstances.

The impact of the adoption of UPMIFA can be summarized as follows:

- UPMIFA updates the prudence standard that applies to the management and investment of charitable funds to more closely conform to the standard used in the Uniform Prudent Investor Act, the Revised Model Nonprofit Corporation Act, and other developments over the past thirty-six years. This helps ensure that the best investment practices govern the actual investment of institutional funds.

- UPMIFA also modernizes the rules governing expenditures from endowment funds, both to provide better guidance on spending from endowment funds and to give institutions the ability to cope more easily with fluctuations in the value of the endowment. [Unless prohibited by terms in the Gift Instrument, UPMIFA allows charitable institutions to use the regular payout formula for "underwater funds."]

- UPMIFA changes the rules related to the release or modification of restrictions on a gift in the event that these restrictions become impracticable or wasteful, including a simplified process of conferring with the California Attorney General on old and small funds where court action may not be warranted.

**yield:** the return from an investment. This includes ordinary income, realized capital gains, and capital appreciation (unrealized capital gains).