BURNS & LEVINSON LLP

CLIENT UPDATE

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Managing Nonprofits in Troubled Times: New Tools in Trustees' Toolbox

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Non-profits, which depend on both the private economy and the public sector, suffer greatly in economic downturns such as we are experiencing at present.

Take healthcare, for example. Consider what happened when the tech-fueled boom of the 1980s – known here as the Massachusetts Miracle – ended. Hospitals were hit hard by a slowdown in Medicaid payments when state tax revenues fell, and a large number of them closed, particularly community hospitals and those that served the inner-city.

In some cases, institutions that failed were sitting on cash they couldn't access. Like Coleridge's Ancient Mariner – surrounded by water, water everywhere, but not a drop to drink – many non-profits had liquid assets they couldn't use to meet payroll because of donor and legal restrictions.

At the time, Massachusetts charities were constrained by rules that prohibited them from accessing the principal of endowment unless expressly permitted to do so by the terms of the gift, and any expenditure of appreciation greater than 7% of a fund's average value was deemed imprudent.

We are now in the midst of a similar downturn that is pinching non-profits' bottom lines. In healthcare, states are being encouraged to expand Medicaid eligibility with no guaranty that the federal government will pick up the tab. In education, another large segment of our non-profit economy, record levels of student loan debt and slim job prospects have produced a new cost-consciousness among potential buyers of bachelors and graduate degrees and increased federal scrutiny.

This time around, however, charities have a more flexible tool to manage their way through trouble. Massachusetts lagged behind the rest of the country in adopting the Uniform Prudent Management of Institutional Funds Act (UPMIFA), but got on board in mid-2009, just as what some now call "The Great Recession" was starting.

The biggest change produced by UPMIFA is that non-profit boards are now free to use the principal of endowment in a prudent manner—and saving the institution itself would surely qualify. Prior law used the concept of a "historic dollar value" of gifts, and precluded charities from using investments that were "underwater," that is, valued at less than the original gift.

The flexibility that UPMIFA gives charities is especially helpful during recessionary times, when the market value of an endowment and revenues from operations often decline in tandem. UPMIFA permits non-profit boards to make management and investment decisions about individual assets not in isolation, but taking into account the institution's overall investment strategy.

This shift to a more holistic view of an institution's charitable funds is important to donors as well, since UPMIFA provides that the term "endowment" is insufficient to prevent an institution from spending the principal of gifts. UPMIFA provides that all management and investment decisions are subject to the intent of the donor expressed in his or her instrument of gift, but that intent cannot be determined solely on the basis of language authorizing a charity to use only "income," "interest," or "dividends."

UPMIFA applies a "prudent person" standard both to board decisions to use endowments, and to board delegations of management and investment functions to others. This is the same standard that applies to officers and directors of non-profits generally, namely, that executives and board members should act in good faith with the care that an ordinarily prudent person in a like position would exercise under similar circumstances. UPMIFA thus brings the management of endowment funds into harmony with the standards that apply to other board decisions.

Boards also have new latitude under UPMIFA to undo donor restrictions. Previously, a court could lift a restriction on a gift under the common law doctrine of "cy pres" (roughly translated, "as near as possible") only when it became impossible, impracticable or illegal to perform, leaving many non-profits in the position of a dowager with family jewels she can't sell. UPMIFA allows restrictions on gifts to be modified when they have become wasteful, impair the management or investment of a fund, or if due to changed circumstances a modification would further the purposes of the fund.

Boards should fully document actions they take consistent with UPMIFA's more forgiving standards, including delegation of management and investment functions, and decisions to spend the principal of endowment and investment policies generally.

Service on a non-profit board becomes more perilous when an institution encounters financial difficulties. Creditors and employees look to the board to right the ship, and the IRS may pursue trustees for unpaid "trust fund" taxes. In the past, non-profit boards were often hamstrung by donor restrictions that left them personally exposed if an institution failed. Under UPMIFA, board members can take comfort that they won't face a "no-win" situation where they are damned if they do use endowment, and damned if they don't.

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