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FOR DISCUSSION ONLY

~~REVISED~~ UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT*

NATIONAL CONFERENCE OF COMMISSIONERS

ON UNIFORM STATE LAWS

WITH PREFATORY NOTE AND PRELIMINARY COMMENTS

The ideas and conclusions set forth in this draft, including the proposed statutory language and any comments or reporter's notes, have not been passed upon by the National Conference of Commissioners on Uniform State Laws or the Drafting Committee. They do not necessarily reflect the views of the Conference and its Commissioners and the Drafting Committee and its Members and Reporters. Proposed statutory language may not be used to ascertain the intent or meaning of any promulgated final statutory proposal.

*Name change pending approval by Executive Committee

January 3, 2006

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~~REVISED~~ UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT

PREFATORY NOTE

In 1972 the National Conference of Commissioners on Uniform State Laws approved the Uniform Management of Institutional Funds Act [hereafter referred to as UMIFA (1972)]. At that time uncertainty existed as to the standards that governed directors of charitable corporations in managing and investing the funds of the charitable organizations. Directors of a charity organized as a nonprofit corporation had been held to the investment standards that applied to trustees of private trusts. *See Lynch v. John M. Redfield Foundation*, 9 Cal. App. 3d 293 (1970) (stating that directors of a charitable corporation are essentially trustees and as such are held to an investment duty similar to that of a trustee of a private trust). *See also* Restatement (Second) of Trusts § 389 (1959). For directors of large institutions, the then-current restrictions on trust investing made the use of modern investment strategies problematic.

UMIFA (1972) provided guidance and authority to the governing boards of those charitable organizations within its scope on several issues. The statute gave a governing board broad investment authority and indicated that a governing board was not restricted to investments authorized for trustees. The statute permitted a board to delegate authority to independent financial advisors. With respect to endowment funds, the statute authorized a governing board to expend unrealized appreciation, even if the endowment fund provided only for the distribution of "income." This provision enabled fund managers to use modern investment techniques such as total-return investing and unitrust-style spending. UMIFA (1972) also permitted the governing board to release restrictions on the use or investment of institutional funds if the donor consented and to release restrictions that had become "obsolete, inappropriate, or impracticable" if a court approved.

The investment standards adopted by UMIFA (1972) foreshadowed changes to trust investment law in the Uniform Prudent Investor Act (1994) [hereafter referred to as UPIA]. UPIA applies modern portfolio theory to trusts, including charitable trusts. The Uniform Principal and Income Act (1997) furthered the principles of UPIA, providing tools for the use of investment techniques authorized under UPIA. The Uniform Trust Code (2000) [hereafter referred to as the UTC] expanded the application of the doctrine of cy pres. These Uniform Acts have informed the work of the Drafting Committee of the Uniform Management of Institutional Funds Act ~~(200-)~~ [hereafter ~~UMIFA~~ UPMIFA ~~(200-)~~].

Objectives of the Act. ~~UMIFA~~ UPMIFA ~~(200-)~~ uses language from UPIA and the Revised Model Nonprofit Corporation Act [hereafter referred to as the RMNCA], reflecting the fact that standards for investing and managing institutional funds are and should be the same regardless of whether a charitable organization is organized as a trust, as a nonprofit corporation or in some other manner. The rules governing expenditures from endowment funds have been modified to give a governing board more flexibility in making expenditure decisions, so that the board can cope with fluctuations in the value of the endowment. As under UMIFA (1972), these rules are available to decision makers of charities organized as charitable trusts, as nonprofit corporations, or in some other manner, but the rules do not apply to a fund managed by a trustee that is not a charity. The Act does not apply to trusts managed by corporate or individual trustees, but the Act does apply to a trust managed by a charity. The provisions governing the release and modification of restrictions have been changed to permit more efficient management of institutional funds.

Other Legal Rules. ~~UMIFA~~ UPMIFA ~~(200-)~~ addresses investment issues and issues relating to endowment funds but is not a comprehensive statute addressing all legal issues that apply to charitable organizations. For matters not governed by ~~UMIFA~~ UPMIFA, ~~(200-),~~ a charitable organization will continue to be governed by rules applicable to charitable trusts, if it is organized as a trust, or rules applicable to nonprofit corporations, if it is organized as a nonprofit corporation.

Trust Law. UPMIFA applies a number of rules from trust law to institutions organized as nonprofit corporations. In two respects UPMIFA creates rules that do not exist under trust law. The endowment spending rule of Section 4 and the small, old fund modification provision of subsection (d) of Section 6 have no counterparts in trust law. The Drafting Committee believes that these rules could be useful to charities organized as trusts, and the Committee recommends amendments to the UTC and the Principal and Income Act to incorporate these changes into trust law.

UNIFORM <u>PRUDENT</u> MANAGEMENT OF INSTITUTIONAL FUNDS ACT

SECTION 1. SHORT TITLE. This [act] may be cited as the Uniform <u>Prudent</u> Management of Institutional Funds Act.

SECTION 2. DEFINITIONS. In this [act]:

(1) "Charitable purpose" means the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of governmental purposes, or another purpose the achievement of which is beneficial to the community.

(2) "Endowment fund" means an institutional fund, or any part thereof, not wholly expendable by the institution on a current basis under the terms of a gift instrument. The term does not include assets of an institution designated by the institution as an endowment fund for its own use.

(3) "Gift instrument" means a record or records under which property is granted to, transferred to, or held by an institution as an institutional fund. The term includes an institutional solicitation in the form of a record from which a gift to the institution results if the solicitation indicates the intent of the institution that the solicitation constitute a gift instrument and another record does not supersede the solicitation.

(4) "Institution" means:

(A) a person, other than an individual, organized and operated exclusively for charitable purposes;

(B) a government, or governmental subdivision, agency, or instrumentality to the extent that it holds funds exclusively for a charitable purpose;

(C) a trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated.

(5) “Institutional fund” means a fund held by an institution exclusively for charitable purposes. The term does not include:

(A) program-related assets;

(B) a fund held for an institution by a trustee that is not an institution; or

(C) a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund.

(6) “Person” means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, public corporation, government, or governmental subdivision, agency, or instrumentality, or any other legal or commercial entity.

(7) “Program-related asset” means an asset held by an institution primarily to accomplish a charitable purpose of the institution and not primarily for appreciation or the ~~producing~~ production of income.

(8) “Record” means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

Preliminary Comment

Subsection (1). Charitable Purpose. The definition of charitable purpose uses the same formulation as that in UTC § 405 and Restatement (Third) of Trusts § 28 (2003). The definition is the standard legal definition of charitable purposes, developed from the definition of charity set forth in the English Statute of Charitable Uses, enacted in 1601. Some 17 states have created statutory definitions of charitable purpose for other purposes. *See, e.g.*, 10 PA. CONS. STAT. § 162.3 (2005) (setting forth a definition of charitable purpose within the Solicitation of Funds for Charitable Purposes Act. The definition includes the words “humane,” “patriotic,” social welfare and advocacy," and "civic.") The definition in subsection (1) applies for purposes of this Act and does not affect other definitions of charitable purpose.

Subsection (2). Endowment Fund. An endowment fund is an institutional fund or a part of an institutional fund that is not wholly expendable by the institution on a current basis. A restriction that makes a fund an endowment fund arises from the terms of a gift instrument. If an institution has more than one endowment fund, under Section 3 the institution can manage and invest some or all endowment funds together. Section 4 and Section 6 must be applied to individual funds and cannot be applied to a group of funds that may be managed collectively for investment purposes.

Board-designated funds are institutional funds but not endowment funds. The rules on expenditures and modification of restrictions in this Act do not apply to restrictions placed by an institution on an otherwise unrestricted fund held by the institution for its own benefit. The institution may be able to change these restrictions itself, subject to internal rules and to the fiduciary duties that apply to those that manage an institution.

If an institution transfers assets to another institution, subject to the restriction that the other institution hold the assets as an endowment, then the second institution will hold the assets as an endowment fund.

Subsection (3). Gift Instrument. The term gift instrument refers to the records that establish the terms of a gift and may consist of more than one document. As used in this definition, "record" is an expansive concept and means a writing in any form, including electronic. The term includes a will, deed, grant, conveyance, agreement, or memorandum, and also includes writings that do not have a donative purpose. For example, under some circumstances the bylaws of the institution, minutes of the board of directors, or canceled checks could be a gift instrument or be one of several records constituting a gift instrument.

Solicitation materials may constitute a gift instrument. For example, a solicitation that suggests in writing that any gifts received pursuant to the solicitation will be held as an endowment may be integrated with other writings and may be considered part of the gift instrument. Whether the terms of the solicitation become part of the gift instrument will depend upon the circumstances of the gift and whether a subsequent writing superseded the terms of the solicitation. Each gift received in response to a solicitation will be subject to any restrictions indicated in the gift instrument that applies to that gift. For example, if an initial gift establishes an endowment fund, and then the charity solicits additional gifts "to be held as part of the Charity X Endowment Fund," those additional gifts will each be subject to the restriction that the gifts be held as part of the endowment fund.

The term gift instrument includes matching funds provided by an employer or some other person. Whether matching funds are treated as part of the endowment fund or otherwise will depend on the terms of the matching gift.

The term gift instrument also includes an appropriation by a legislature or other public or governmental body for the benefit of an institution.

Subsection (4). Institution. The Act applies generally to institutions organized and operated exclusively for charitable purposes. By defining institution as a person, the term includes charitable organizations created as nonprofit corporations, trusts, unincorporated associations, governmental subdivisions or agencies, or any form of entity, however organized, that is organized and operated exclusively for charitable purposes. The term 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 (1972). The exclusion of "individual" from the definition of institution is not intended to exclude a corporation sole.

In many respects, changes in trust law have caught up with the provisions in UMIFA (1972), so the exclusion of certain trusts from UMIFA ~~(200-)~~ does not mean that many of the rules of ~~UMIFA~~ UPMIFA ~~(200-)~~ will not apply to those trusts. Prudent investor standards apply to trustees of charitable trusts in states that have adopted UPIA, trustees can use the doctrines of cy pres and deviation to modify trust provisions, and the Uniform Principal and Income Act, where enacted, permits allocation between principal and income to facilitate total-return investing. Charitable trusts not included in ~~UMIFA~~ UPMIFA, ~~(200-),~~ primarily those managed by corporate trustees, will lose the benefits of ~~UMIFA~~ UPMIFA's endowment spending rule and the provision permitting a charity to apply cy pres, without court supervision, for modifications to a small, old fund. Enacting jurisdictions may choose to incorporate these rules into existing trust statutes to provide the benefits to charitable funds managed by corporate trustees.

The definition of institution includes governmental organizations that hold funds exclusively for the purposes listed in the definition. Some organizations created by state government may fall outside the definition due to the way in which the state created the organizations. Because state arrangements are so varied, creating a definition that encompasses all charitable entities created by states is not feasible. States should consider the core principles of ~~UMIFA~~ UPMIFA ~~(200-)~~ for application to governmental institutions. For example, the control over a state university may be held by a State Board of Regents. In that situation, the state may have created a governing structure by statute or in the state constitution so that the university is, in effect, privately chartered. The Drafting Committee does not intend to exclude these universities from the definition of institution, but additional state legislation may be necessary to address particular situations.

Subsection (5). Institutional Fund. The term institutional fund includes any fund held by an institution for charitable purposes, whether expendable currently or subject to restrictions. The term does not include a fund held by a trustee that is not an institution.

Some institutions combine assets from multiple funds for investment purposes, and some institutions combine funds from different institutions to invest in a common fund. Typically each fund is assigned units representing the value of the individual fund. The assets can then be invested collectively, permitting more efficient investment and improved diversity of the overall portfolio. The collective fund makes annual distributions to the individual funds based on the units held by each fund. For purposes of Section 3 [and Section 5], the collective fund is considered one institutional fund. Section 4 and Section 6 apply to each fund individually and not to the collective fund.

Assets held by an institution primarily for program-related purposes are not subject to ~~UMIFA~~ UPMIFA. ~~(200).~~ Assets used to carry out a charity's program should not be subject to the same investment standards that apply to assets held primarily for investment purposes. For example, a university may purchase land adjacent to its campus for future development. The purchase might not meet prudent investor standards, but the purchase may be appropriate because the university needs to build a new dormitory. The classroom buildings, administration buildings, and dormitories held by the university all have value as property, but the university does not hold those buildings for investment purposes. The Act excludes from the prudent investor norms those assets that a charity uses to conduct its charitable activities, but does not exclude assets that have a tangential tie to the charitable purpose of the institution but are held primarily for investment purposes.

A fund held by an institution is not an institutional fund if any beneficiary of the fund is not an institution. For example, a charitable remainder trust held by a charity as trustee for the benefit of the donor during the donor's lifetime, with the remainder interest held by the charity, is not an institutional fund. However, this subsection treats as an institution a charitable remainder trust that continues to operate for charitable purposes after the termination of the noncharitable interests. The Act will have only a limited effect on a charitable remainder trust during the period required to complete the distribution of the trust's property after the noncharitable interest ends. The prudence norm will apply to the actions of the trustee, but the trustee will make decisions about investment and management of funds knowing that the trust will distribute its assets and not continue indefinitely.

Subsection (6). Person. The Act uses as the definition of person the definition approved by the National Conference of Commissioners on Uniform State Laws. The definition of institution uses the term person, but to be an institution a person must be organized and operated exclusively for charitable purposes. A person with a commercial purpose cannot be an institution. Thus, although the definition of person includes "business trust" and "any other . . . commercial entity," the Act does not apply to an entity organized for business purposes and not exclusively for charitable purposes. Further, the definition of person includes trusts, but only trusts managed by charities can be institutional funds. ~~UMIFA~~ UPMIFA ~~(200)~~ does not apply to trusts managed by corporate trustees or by individual trustees.

If a governing instrument provides that a fund will revert to the donor if, and only if, the institution ceases to exist or the purposes of the fund fail, then the fund will be considered an institutional fund until such contingency occurs.

Subsection (7). Program-Related Asset. Although ~~UMIFA~~ UPMIFA ~~(200)~~ does not apply to program-related assets, if program-related assets serve, in part, as investments for an institution, then the institution should identify categories for reporting those investments and should establish investment criteria for the investments that are reasonably related to achieving the institution's charitable purposes. For example, a program providing below-market loans to inner-city businesses may be "primarily to accomplish a charitable purpose of the institution" but also can be considered, in part, an investment. The institution should create reasonable credit standards and other guidelines for the program to increase the likelihood that the loans would be repaid.

Subsection (8). Record. This definition was added to clarify that the definition of instrument includes electronic records as defined in Section 2(8) of the Uniform Electronic Transactions Act (1999).

SECTION 3. STANDARD OF CONDUCT IN MANAGING AND INVESTING INSTITUTIONAL FUND.

(a) Subject to the intent of a donor expressed in a gift instrument, an institution, in managing and investing an institutional fund, shall consider the charitable purposes of the institution and the purposes of the institutional fund.

(b) In addition to complying with the duty of loyalty imposed by law other than this [act], each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.

(c) In managing and investing an institutional fund, an institution:

(1) may incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution; and

(2) shall make a reasonable effort to verify facts relevant to the management and investment of the fund.

(d) An institution may pool two or more institutional funds for purposes of management and investment.

(e) Except as otherwise provided by a gift instrument, the following rules apply:

(1) In managing and investing an institutional fund, the following factors, if relevant, must be considered:

(A) general economic conditions;

(B) the possible effect of inflation or deflation;

(C) the expected tax consequences, if any, of investment decisions or strategies;

(D) the role that each investment or course of action plays within the overall investment portfolio of the fund;

(E) the expected total return from income and the appreciation of investments;

(F) other resources of the institution;

(G) the needs of the institution and the fund to make distributions and to preserve capital; and

(H) an asset's special relationship or special value, if any, to the charitable purposes of the institution.

(2) Management and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution.

(3) An institution, subject to law other than this act, may invest in any kind of property or type of investment consistent with the standards of this section.

(4) An institution shall diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversifying.

(5) Within a reasonable time after receiving property, an institution shall make and implement decisions concerning the retention or disposition of the property or to rebalance a portfolio, in order to bring the institutional fund into compliance with the purposes, terms, distribution requirements, and other circumstances of the institution and the requirements of this [act].

(6) ~~An individual~~ A person who has special skills or expertise, or is ~~named~~ selected in reliance upon the ~~individual~~ person's representation that the ~~individual~~ person has special skills or expertise, has a duty to use those special skills or that expertise in managing and investing institutional funds.

Preliminary Comment

Purpose and Scope of Revisions. This section adopts the prudence standard for investment decision making. The section directs directors or others responsible for managing and investing the funds of an institution to act as a prudent investor would, using a portfolio approach in making investments and considering the risk and return objectives of the fund. The section lists the factors that commonly bear on decisions in fiduciary investing and incorporates the duty to diversify investments absent a conclusion that special circumstances make a decision not to diversify reasonable. Thus, the section follows modern portfolio theory for investment decision making. Section 3 applies to all funds held by an institution, regardless of whether the institution obtained the funds by gift or otherwise and regardless of whether the funds are restricted.

The Drafting Committee discussed at great length the standard that should govern nonprofit managers. UMIFA (1972) states the standard as "ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision." Since the decision in *Stern v. Lucy Webb Hayes National Training School for Deaconesses*, 381 F. Supp. 1003 (1974), the trend has been to hold directors of nonprofit corporations to a standard similar to the corporate standard but with the recognition that the facts and circumstances considered include the fact that the entity is a charity and not a business corporation.

The language of the prudence standard adopted in ~~UMIFA~~UPMIFA ~~(200)~~ is derived from the RMNCA and from the prudent investor rule of UPIA. The standard is consistent with the business judgment standard under corporate law, *as applied to charitable institutions*. That is, a manager operating a charitable organization under the business judgment rule would look to the same factors as those identified by the prudent investor rule. The standard for prudent investment set forth in Section 3 first states the duty of care as articulated in the RMNCA. The standard then provides more specific guidance for those managing and investing institutional funds by incorporating language from UPIA. The factors and rules derived from UPIA are consistent with good practice under current law applicable to nonprofit corporations.

Trust law norms already inform managers of nonprofit corporations. The Preamble to UPIA explains: "Although the Uniform Prudent Investor Act by its terms applies to trusts and not to charitable corporations, the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations." *See also*, Restatement (Third) of Trusts: Prudent Investor Rule § 379, Comment b, at 190 (1992) (stating "absent a contrary statute or other provision, the prudent investor rule applies to investment of funds held for charitable corporations."). Trust precedents have always been helpful but not binding authority in corporate cases.

The Drafting Committee decided that by adopting language from both the RMNCA and UPIA, ~~UMIFA~~UPMIFA ~~(200)~~ could clarify that the same standards of prudent investing apply to all charitable institutions. Although principal trust authorities, UPIA § (2)(a), Restatement (Third) of Trusts §337, UTC § 804, and Restatement (Second) of Trusts § 174 (prudent administration) use the phrase "care, skill and caution," the Drafting Committee decided to use the more familiar corporate formulation as found in RMNCA. The standard also appears in Sections 3, 4 and 5 of ~~UMIFA~~ UPMIFA ~~(200)~~. The Drafting Committee does not intend any substantive change to the UPIA standard and believes that "reasonable care, skill, and caution" are implicit in the term "care" as used in the RMNCA. The Drafting Committee included the detailed provisions from UPIA, because the Committee believed that the greater precision of the prudence norms of the Restatement and UPIA, as compared with UMIFA (1972), could helpfully inform managers of charitable institutions. For an explanation of the Prudent Investor Act, see John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 Iowa L. Rev. 641 (1996).

Section 3 has incorporated the provisions of UPIA with only a few exceptions. UPIA applies to private trusts and thus is entirely default law. A settlor of a private trust has complete control over trust provisions. Because ~~UMIFA~~UPMIFA ~~(200)~~ applies to charitable organizations, ~~UMIFA~~UPMIFA ~~(200)~~ makes the duty of care, the duty to minimize costs, and the duty to investigate mandatory. The duty of loyalty is mandatory under other law. Other than these duties, the provisions of Section 3 are default rules. A gift instrument or the governing instruments of an institution can modify these duties, but the charitable purpose doctrine limits the extent to which an institution or a donor can restrict these duties. In addition, subsection (a) of Section 3 reminds the decision maker that the intent of a donor expressed in a gift instrument will control decision making. Further, the decision maker must consider the charitable purposes of the institution and the purposes of the institutional fund for which decisions are being made.

These factors are specific to charitable organizations, but UPIA § 2(a) states the duty to consider similar factors in the private trust context.

~~UMIFA~~UPMIFA ~~(200)~~ does not include the duty of impartiality, stated in UPIA § 6, because the duty under UPIA did not make sense when applied to charities created as nonprofit corporations. Under UPIA, a trustee must treat the current beneficiaries and the remainder beneficiaries impartially, subject to alternative direction from the trust document. A nonprofit corporation typically creates one charity. The institution may serve multiple beneficiaries, but those beneficiaries do not have enforceable rights in the institution in the same way that beneficiaries of a private trust do. Of course, if a charitable trust is created to benefit more than one charity, rather than being created to carry out a charitable purpose, then UPIA will apply the duty of impartiality to that trust.

In other respects, the Drafting Committee made changes to language from UPIA only where necessary to make the language appropriate for charitable institutions. No material differences are intended. Subsection ~~(d)~~ (e) (1)(D) of Section 3 does not include a clause that appears at the end of UPIA § 2(c)(4) ("which may include financial assets, interest in closely held enterprises, tangible and intangible personal property, and real property."). The Drafting Committee deemed this clause unnecessary for charitable institutions. The language of subsection ~~(d)~~ (e) (1)(G) reflects a modification of the language of UPIA § (2)(c)(7). Other minor modifications to the UPIA provisions make the language more appropriate for charitable institutions.

The duties imposed by this section apply to those who govern an institution, including directors and trustees, and to those to whom the directors or managers delegate responsibility for investment and management of institutional funds. The standard applies to officers and employees of an institution and to agents who invest and manage institutional funds. Volunteers who work with an institution will be subject to the duties imposed here, but state and federal statutes may provide reduced monetary liability for persons who act without compensation. ~~UMIFA~~UPMIFA does not affect the application of those monetary liability shield statutes.

Subsection (a). Donor Intent and Charitable Purposes. Subsection (a) states the overarching direction provided by the donor's intent as expressed in the terms of the gift instrument and the duty to consider the charitable purposes of the institution and of the institutional fund. A charity must comply with restrictions imposed on a gift by a donor, but the emphasis in the Act on giving effect to donor intent does not mean that the donor can or should control the management of the institution. The UPIA counterpart of subsection (a) is UPIA § 2(a).

Subsection (b). Duty of Loyalty. Subsection (b) reminds those managing and investing institutional funds that the duty of loyalty will apply to their actions, but Section 3 does not state the loyalty standard that applies. The Drafting Committee was concerned that different standards of loyalty may apply to directors of nonprofit corporations and trustees of charitable trusts. The RMNCA provides that under the duty of loyalty a director of a nonprofit corporation should act "in a manner the director reasonably believes to be in the best interests of the corporation."

RMNCA § 8.30. The trust law articulation of the loyalty standard uses "sole interests" rather than "best interests." As the Restatement of Trusts explains, "[t]he trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary." Restatement (Second) of Trusts § 170 (1). Although the standards for loyalty, like the standard of care, are merging, *see* Evelyn Brody, *Charitable Governance: What's Trust Law Got to do With It?* Chi.-Kent L. Rev. (2005); John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest*, 114 Yale L.J. 929 (2005), the Drafting Committee concluded that incorporating the duty of loyalty into ~~UMIFA~~UPMIFA ~~(200)~~ was unnecessary. Thus the duty of loyalty under nonprofit corporation law will apply to charities organized as nonprofit corporations, and the duty of loyalty under trust law will apply to charitable trusts.

Subsection (b). Duty of Care. Subsection (b) also applies the duty of care to performance of investment duties. The language derives from § 8.30 of the RMNCA. This subsection states the duty to act in good faith, "with the care an ordinarily prudent person in a like position would exercise under similar circumstances." Although the language in the RMNCA and in ~~UMIFA~~UPMIFA ~~(200)~~ is similar to that of § 8.30 of the Model Business Corporation Act (3d ed. 2002), the standard as applied to persons making decisions for charities is informed by the fact that the institution is a charity and not a business corporation. Thus, in ~~UMIFA~~UPMIFA ~~(200)~~ the references to "like position" and "similar circumstances" mean that the charitable nature of the institution affects the decision making of a prudent person acting under the standard set forth in subsection (b). The duty of care involves considering the factors set forth in subsection ~~(d)~~ (e)(1).

Subsection (c)(1). Duty to Minimize Costs. Subsection (c)(1) tracks the language of UPIA § 7 and requires an institution to minimize costs. An institution may prudently incur costs by hiring an investment advisor, but the costs incurred should be appropriate under the circumstances. *See* UPIA § 7 cmt.; Restatement (Third) of Trusts: Prudent Investor Rule § 227, cmt. M, at 58 (1992); Restatement (Second) of Trusts § 188 (1959). The duty is consistent with the duty to act prudently under § 8.30 of the RMNCA.

Subsection (c)(2). Duty to Investigate. This subsection incorporates the traditional fiduciary duty to investigate, using language from UPIA § 2(d). The subsection requires persons who make investment and management decisions to investigate the accuracy of the information used in making decisions.

Subsection (d). Pooling Funds. An institution holding more than one institutional fund may find that pooling its funds for investment and management purposes will be economically beneficial. The Act permits pooling for these purposes, and the prohibition against commingling from trust law does not apply to the extent necessary to pool funds for investment and management purposes. *See* Restatement (Third) of Trusts: Duty to Segregate and Identify Trust Property § 84 (T.D. No. 4 2005). Funds will be considered individually for other purposes of the Act, including for the spending rule for endowment funds of Section 4 and the modification rules of Section 6.

Subsection ~~(d)~~ (e) (1). Prudent Decision Making. Subsection ~~(d)~~ (e) (1) takes much of its language from UPIA § 2(c). In making decisions about whether to acquire or retain an asset, the institution should consider the institution's mission, its current programs, and the desire to cultivate additional donations from a donor, in addition to factors related more directly to the asset's potential as an investment.

Subsection ~~(d)~~ (e) (1)(C) reflects the fact that some organizations will invest in taxable investments that may generate unrelated business taxable income for income tax purposes.

Assets held primarily for program-related purposes are not subject to ~~UMIFA~~ UPMIFA ~~(200)~~. The management of those assets will continue to be governed by other laws applicable to the institution. Other assets may not be held primarily for program-related purposes but may have both investment purposes and program-related purposes. Subsections (a) and ~~(d)~~ (e) (1)(H) indicate that a prudent decision maker can take into consideration the relationship between an investment and the purposes of the institution and of the institutional fund in making an investment that may have a program-related purpose but not be primarily program-related. The degree to which an institution uses an asset to accomplish a charitable purpose will affect the weight given that factor in a decision to acquire or retain the asset.

Subsection ~~(d)~~ (e) (2). Portfolio Approach. This subsection reflects the spread of portfolio theory in modern investment practice. The language comes from UPIA § 2(b), which follows the articulation of the prudent investor standard in Restatement (Third) of Trusts: Prudent Investor Rule § 227(a) (1992).

Subsection ~~(d)~~ (e) (3). Broad Investment Authority. Consistent with the portfolio theory of investment, this subsection permits a broad range of investments. The language derives from UPIA § 2(e).

Section 4 of UMIFA (1972) indicated that an institution could invest "without restriction to investments a fiduciary may make." The committee removed this language from subsection ~~(d)~~ (e) (3) as unnecessary because states no longer have legal lists restricting fiduciary investing to the specific types of investments identified in statutory lists.

Subsection ~~(d)~~ (e) (3) also provides that other law may limit the authority under this subsection. In addition, all of subsection ~~(d)~~ (e) is subject to contrary provisions in a gift instrument, and a gift instrument may restrict the ability to invest in particular assets. For example, the gift instrument for a particular institutional fund might preclude the institution from investing the assets of the fund in companies that produce tobacco products.

In her book, Governing Nonprofit Organizations: Federal and State Law and Regulation 434 (Harv. Univ. Press 2004), Marion R. Fremont-Smith notes that some large charities pledge their endowment funds as security for loans. Subsection (e)(3) permits this sort of debt financing, subject to the guidelines of subsection (e)(1).

Subsection ~~(d)~~ (e) (4). Duty to Diversify. This subsection assumes that prudence requires diversification but permits an institution to determine that nondiversification is appropriate under the circumstances applicable to a fund. A decision to retain property due to "special circumstances" must be made based on the needs of the charity and not solely for the benefit of a donor. A decision to retain property in the hope of obtaining additional contributions from the same donor may be considered made for the benefit of the charity, but the appropriateness of that decision will depend on the circumstances. This subsection derives its language from UPIA § 3. *See* UPIA § 3 cmt. (discussing the rationale for diversification); Restatement (Third) of Trusts: Prudent Investor Rule § 227 (1992).

Subsection ~~(d)~~ (e) (5). Disposing of Unsuitable Assets. This subsection imposes a duty on an institution to review the suitability of retaining property contributed to the institution within a reasonable period of time after the institution receives the property. Subsection ~~(d)~~ (e) (5) requires the institution to make a decision but does not require a particular outcome. The institution may consider a variety of factors in making its decision, and a decision to retain the property either for a period of time or indefinitely may be a prudent decision.

Section 4(2) of UMIFA (1972) specifically authorized an institution to retain property contributed by a donor. The comment explained that an institution might retain property in the hope of obtaining additional contributions from the donor. This concept continues under ~~UMIFA~~UPMIFA ~~(200-)~~, because the potential for developing additional contributions by retaining property contributed to the institution is one of the "other circumstances" the institution may consider in deciding whether to retain or dispose of the property. The institution must weigh the potential for obtaining additional contributions with all other factors that affect the suitability of retaining the property in the investment portfolio.

The language of subsection ~~(d)~~ (e) (5) comes from UPIA § 4, which restates Restatement (Third) of Trusts: Prudent Investor Rule § 229 (1992), which itself took language from Restatement (Second) of Trusts § 231 (1959). *See* UPIA § 4 cmt.

Subsection ~~(d)~~ (e) (6). Special Skills or Expertise. Subsection ~~(d)~~ (e) (6) states the rule provided in UPIA § 2(f) requiring a trustee to use the trustee's own skills and expertise in carrying out the trustee's fiduciary duties. The comment to RMNCA § 8.30 describes the existence of a similar rule under the law of nonprofit corporations. Section 8.30(a)(2) provides that in discharging duties a director must act "with the care an ordinarily prudent person in a like position would exercise under similar circumstances. . . ." The comment explains that"[t]he concept of 'under similar circumstances' relates not only to the circumstances of the corporation but to the special background, qualifications, and management experience of the individual director and the role the director plays in the corporation." After describing directors chosen for their ability to raise money, the comment notes that "[n]o special skill or expertise should be expected from such directors unless their background or knowledge evidences some special ability."

The intent of subsection ~~(d)~~ (e) (6) is that a person managing or investing institutional funds must use the person's own judgment and experience, including any particular skills or expertise, in carrying out the management or investment duties. For example, if a charity names a person as a director in part because the person is a lawyer, the lawyer's background may allow the lawyer to recognize legal issues in connection with funds held by the charity. The lawyer should identify the issues for the board, but the lawyer is not expected to provide legal advice. *See* ALI Principles of Corporate Governance, Council Draft No. 2 (Nov. 18, 2004) § 315 (Duty of Care), cmt. b.

UMIFA (1972) contained two provisions that authorized investments in pooled or common investment funds. UMIFA (1972) §§ 4(3), 4(4). The Drafting Committee concluded that Section 3~~(d)~~ (e) (3) of ~~UMIFA~~UPMIFA ~~(200-)~~ authorizes these investments. The decision not to include the two provisions in ~~UMIFA~~UPMIFA ~~(200-)~~ implies no disapproval of such investments.

SECTION 4. EXPENDITURE OF ENDOWMENT FUND; RULES OF CONSTRUCTION.

(a) Subject to the intent of a donor expressed in a gift instrument [and to subsection (d)], an institution may ~~expend~~ appropriate for expenditure or accumulate so much of an endowment fund as the institution determines to be prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. Unless stated otherwise in a gift instrument, the assets in an endowment fund are donor restricted assets until appropriated for expenditure by the institution. In making ~~its~~ a determination~~s on~~ to appropriate or accumulate ~~expenditures and accumulations,~~ the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following factors:

(1) the duration and preservation of the endowment fund;

(2) the purposes of the institution and the endowment fund;

(3) general economic conditions;

(4) the possible effect of inflation or deflation;

(5) the expected total return from income and the appreciation of investments;

(6) other resources of the institution; and

(7) the investment policy of the institution.

(b) To limit the authority to expend or accumulate funds under subsection (a), a gift instrument must specifically state the limitation.

(c) Terms in a gift instrument designating a gift as an endowment, or a direction or authorization in the gift instrument to use only “income”, “interest”, “dividends”, or “rents, issues, or profits”, or “to preserve the principal intact”, or similar words:

(1) create an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund: and

(2) do not otherwise limit the authority to expend or accumulate under subsection (a).

[(d) The appropriation for expenditure in any ~~one~~ year of an amount greater than seven percent of the fair market value of the endowment fund, calculated on the basis of market values determined at least quarterly and averaged over ~~the three-year period~~ a period not less than three nor more than five years immediately preceding the year in which the appropriation for expenditure was made, creates a rebuttable presumption of imprudence. For an endowment fund in existence for fewer than three years, the fair market value of the endowment fund will be calculated for the period of time the endowment fund has been in existence. This subsection does not:

(1) limit the authority to make expenditures as permitted under law other than this [act] or the gift instrument; and ~~.~~

~~This subsection does not~~ (2) create a presumption of prudence for the appropriation for expenditure of an amount less than or equal to seven percent of the fair market value of the endowment fund.]

Preliminary Comment

Purpose and Scope of Revisions. This section revises the provision in UMIFA (1972) that permitted the expenditure of appreciation of an endowment fund to the extent the fund had appreciated in value above the fund's historic dollar value. UMIFA (1972) defined historic dollar value to mean the value of all contributions to the fund. The new approach abandons the use of historic dollar value. As under UMIFA (1972), the act applies a prudence standard to the process of making decisions about expenditures from an endowment fund. The expenditure rule of Section 4 applies only to the extent that a donor and an institution have not reached some other agreement about spending from an endowment. If a gift instrument sets forth specific requirements for spending, then the charity must comply with those requirements. However, if the gift instrument uses more general language, for example directing the charity to "hold the fund as an endowment" or "retain principal and spend income," then Section 4 provides a rule of construction to guide the charity.

One of the difficulties addressed by UMIFA (1972) and ~~UMIFA~~UPMIFA ~~(200-)~~ is that the definition of "income" has changed over time. Prior to the promulgation of UMIFA (1972), "income" for trust accounting purposes meant interest and stock dividends but not capital gains, even realized capital gains. UMIFA (1972) addressed this problem by including a construction provision, construing "income" in gift instruments to include a prudent amount of capital gains, both realized and unrealized. This rule of construction, applied to the term "income" and to other similar expressions in a gift instrument, likely carried out the intent of the donor who used the term, while permitting the charity to invest in a manner that could generate better returns for the fund.

~~UMIFA~~UPMIFA ~~(200-)~~ also applies a rule of construction to terms like "income" or "endowment." The assumption in the Act is that a donor who uses one of these terms intends to create a fund that will generate sufficient gains to be able to make ongoing distributions from the fund while at the same time preserving the purchasing power of the fund. Because historic dollar value under UMIFA (1972) was a number fixed in time, the use of that approach may not have adequately captured the intent of a donor who wanted the endowment fund to continue to maintain its value in current dollars.

~~UMIFA~~UPMIFA ~~(200)~~ requires the persons making spending decisions for an endowment fund to focus on the purposes of the endowment fund and not the purposes of the institution more generally, as was the case under UMIFA (1972). When the institution considers the purposes and duration of the fund, the institution will give priority to the donor's general intent that the fund be maintained indefinitely. Although the Act does not require that a specific amount be set aside as "principal," the Act assumes that the charity will act to preserve "principal" (i.e., to maintain the purchasing power of the fund) while spending "income" (i.e. making a distribution each year that represents a reasonable spending rate, given investment performance and general economic conditions).

Subsection (a). Expenditure of Endowment Funds. Subsection (a) uses the RMNCA articulation of the standard of care for decision making under Section 4. The change in language does not reflect a substantive change. The comment to Section 3 more fully describes this standard of care.

Section 4 permits expenditures from an endowment fund to the extent the institution determines that the expenditures are prudent after considering the factors listed in subsection (a). These factors emphasize the importance of keeping in mind the intent of the donor, as expressed in a gift instrument. Section 4 relies on written documents as evidence of donor's intent and does not require an institution to rely on oral expressions of intent because conversations over lunch and other oral expressions of intent may be misremembered and may be subject to multiple interpretations. Of course, oral expressions of intent may guide an institution in carrying out a donor's wishes and can be used by the institution in understanding a donor's intent. By requiring written evidence of intent, however, the Act protects reliance by the donor and the institution on the written terms of a donative agreement.

The factors in subsection (a) require the institution to focus on ~~and~~ the purposes of the institution and of the endowment fund, while also considering economic conditions as well as present and reasonably anticipated resources of the institution. As under UMIFA (1972), determinations under Section 4 do not depend on the characterization of assets as income or principal and are not limited to the amount of income and unrealized appreciation. The rule in Section 4 is permissive, however, and an institution organized as a trust may continue to make spending decisions under trust accounting principles if it prefers.

Institutions have operated effectively under UMIFA (1972) and have operated more conservatively than the historic dollar value rule would have permitted. Institutions have no incentive to spend everything the law may permit them to spend, and good practice has been to provide for modest expenditures while maintaining the purchasing power of a fund. Institutions have followed this approach even though UMIFA (1972) does not require an institution to maintain a fund's purchasing power and allows an institution to spend any amounts in a fund above historic dollar value, subject to the prudence standard. The Drafting Committee concluded that eliminating historic dollar value and providing institutions with more discretion would not lead to depletion of endowment funds. Instead, ~~UMIFA~~UPMIFA ~~(200)~~ should encourage institutions to establish a spending approach that will be responsive to short-term fluctuations in the value of the fund. Section 4 allows an institution to maintain appropriate levels of expenditures in times of economic downturn or economic strength. In some years, accumulation rather than spending will be prudent, and in other years an institution may appropriately make expenditures even if a fund has generated no investment return that year.

Several levels of safeguards exist to prevent institutions from depleting endowment funds or diverting funds from the purposes for which they were created. In comparison with UMIFA (1972), ~~UMIFA~~UPMIFA ~~(200-)~~ provides greater direction to the institution with respect to making a prudent determination about spending from an endowment. UMIFA (1972) told the decision maker to consider "long and short term needs of the institution in carrying out its educational, religious, charitable, or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions." ~~UMIFA~~UPMIFA ~~(200-)~~ clarifies that in making spending decisions the institution should focus on the fact that the fund is an endowment and should attempt to ensure that the value of the fund endures while still providing that some amounts be spent for the purposes of the endowment fund. In ~~UMIFA~~UPMIFA ~~(200-)~~ prudent decision making emphasizes the endowment aspect of the fund, rather than the overall purposes or needs of the institution.

In addition to the guidance provided by Section 4, other safeguards exist. Donors can restrict gifts and can provide specific instructions to donee institutions as to appropriate uses for assets contributed. Within institutions, fiduciary duties govern the persons making decisions on expenditures. Those persons must operate both with the best interests of the institution in mind and in keeping with the intent of donors. If an institution diverts an institutional fund from the charitable purposes of the institution, the state attorney general can enforce the charitable interests of the public. By relying on these safeguards while providing institutions with adequate discretion to make decisions on appropriate expenditures, the Act creates a standard that takes into consideration the diversity of the charitable sector. The committee expects that industry standards will continue to evolve and inform institutions as the institutions apply this standard.

Section 4 provides factors to consider in exercising discretion but does not take away discretion by providing a safe harbor for spending within a range based on percentages of the assets of the fund. The Committee concluded that specifying a range for appropriate distributions was unwise because a fixed range could not take into account the factors listed in subsection (a) or changes in market conditions. A fixed range that might be appropriate for some charities under current economic conditions would be unlikely to remain appropriate over time. Most institutions have done a good job of developing spending policies under UMIFA (1972) and should be able to continue to develop spending policies that take into consideration the specific needs of a particular fund. [cite] Prudent decision making after considering all the factors is the standard under ~~UMIFA~~UPMIFA ~~(200-)~~. A safe-harbor would simply create a new standard that could not take into account the needs of individual institutions and funds.

The changes from UMIFA (1972), and in particular the deletion of historic dollar value, are not intended to make any portion of an endowment fund unrestricted assets from a legal standpoint. An endowment fund is restricted because of the donor's intent that ~~it~~ the fund be restricted by the prudent spending rule, that the fund not be spent in the current year, and ~~the~~

~~intent~~ that the fund continue to maintain its value for a long time. ~~Spending decisions are subject to that general restriction as well as to the restriction that any decision to spend must be prudent, made after considering the factors set forth in Section 4(a).~~ Regardless of the treatment of endowment fund from an accounting standpoint, legally an endowment fund should not be considered unrestricted. [cite to Utah and Maine UMIFA statutes and to Mass. AG opinion No. 117 (January 2004) concerning the treatment of endowments as legally restricted assets].

The term "endowment fund" includes funds that may last in perpetuity but also funds that are created to last for a fixed term of years or until the institution achieves a specified objective. Section 4 requires the institution to consider the intended duration of the fund in making determinations about spending. For example, if a donor directs that a fund be spent over 20 years, Section 4 will guide the institution in making distribution decisions. The institution would amortize the fund over 20 years rather than try to maintain the fund in perpetuity. For an endowment fund of limited duration, spending at a rate higher than rates typically used for endowment spending will be both necessary and prudent.

Subsection (c). Rule of Construction. Donor's intent must be respected in the process of making decisions to expend endowment funds. Section 4 does not allow an institution to convert an endowment fund into a non-endowment fund nor does the section allow the institution to ignore a donor's intent that a fund be maintained as an endowment. Rather, subsection (c) provides rules of construction to assist institutions in interpreting donor's intent. Subsection (c) assumes that if a donor wants an institution to spend "only the income" from a fund, the donor intends that the fund both support current expenditures and be preserved indefinitely. The donor is unlikely to be concerned about designation of returns as "income" or "principal" under accounting principles. Rather the donor likely assumes that the institution will use modern investing strategies like total-return investing to generate enough funds to distribute while maintaining the long-term viability of the fund. Subsection (c) is an intent effectuating provision that provides default rules to construe donor's intent.

As subsection (b) explains, a donor who wants to specify spending guidelines can do so, but must do so specifically. For example, a donor might require that a charity spend between three and five percent of an endowed gift each year, regardless of investment performance or other factors. If the charity agrees to the restriction in accepting the gift, the restriction will govern spending decisions by the charity. Another donor might want to limit expenditures from an endowment gift to accounting income and not want the institution to be able to expend appreciation. An instruction to "pay only the income" will not be specific enough, but an instruction to "pay only interest and dividend income earned by the fund and not to make other distributions of the kind authorized by Section 4 of ~~UMIFA~~UPMIFA" should be sufficient. If a donor indicates that the rules on investing or expenditures under Section 4 do not apply to a particular fund, then as a practical matter the institution will probably invest the fund separately. Thus, a decision by a donor to require specific expenditure rules will likely also have consequences in the way the institution invests the fund.

A default rule resolves an ambiguity. Statutes use default rules to fill gaps when the actors involved have not clearly stated their intents. In ~~UMIFA~~UPMIFA ~~(200-)~~, the rule of construction in subsection (c) aids institutions in construing the intent of donors who use words like endowment or income without specific directions as to the intended meaning. Changing a default rule does not change the underlying intent. Instead, a change in the rule of construction changes the way an ambiguity is resolved, in an attempt to increase the likelihood of giving effect to the intent of most donors.

This issue, the retroactive application of a rule of construction, was considered in connection with UMIFA (1972). When the New Hampshire legislature considered UMIFA (1972), the Senate asked the New Hampshire Supreme Court for an opinion as to whether UMIFA (1972), if adopted, would violate a provision of the state constitution prohibiting retrospective laws and whether the statute would be an encroachment on the functions of the judicial branch. The opinion answered no to both questions. Opinion of the Justices, Request of the Senate No. 6667, 113 N.H. 287, 306 A.2d 55 (1973).

~~[New Hampshire case].~~ More recently the Colorado Supreme Court considered the retroactive application of another default statute, one that treats the designation of a spouse as the beneficiary of a life insurance policy as revoked when the spouses dissolve their marriage. *See* In re Estate of DeWitt, 54 P. 3d 849 (Colo. 2002). In holding that retroactive application of the statute did not violate the Contracts Clause, the court cited approvingly from a statement prepared by the Joint Editorial Board for Uniform Trusts and Estates Acts (the "JEB"). JEB Statement Regarding the Constitutionality of Changes in Default Rules as Applied to PreExisting Documents, 17 Am. Coll. Tr. & Est. Couns. Notes 184 app. II (1991). The JEB Statement explains why retroactive application of default statutes is appropriate and is not unconstitutional and states, "The JEB is aware of no authority for the application of the Contracts Clause to state legislation applying altered rules of construction or other default rules to pre-existing documents in any field of law, and especially not in the field of estates, trusts, and donative transfers." *Id.* at 4 (citing J. Nowak & R. Rotunda, Constitutional Law § 11.8, at 394 et seq. (4th ed. 1991)). As the JEB Statement explains, the purpose of the anti-retroactivity norm is to protect transferors who rely on existing rules of law. By definition, however, rules of construction apply only in situations in which a transferor did not spell out his or her intent. *See also In re Gardner's Trust*, 266 Minn. 127, 132, 123 N.W. 2d 69, 73 (1963).

The Drafting Committee was also concerned that retaining the historic dollar value concept for endowment funds in existence before the enactment of ~~UMIFA~~UPMIFA ~~(200-)~~ would require institutions to manage endowment funds separately. For example, an institution with an endowment fund for scholarships would have to create a new fund for post-enactment contributions. Managing two funds would result in economic inefficiencies and greater administration costs for the institution. Further, an institution with a fund created under UMIFA (1972) with a value below historic dollar value might choose to invest in assets that produce trust accounting income rather than appreciation. Choosing investments based on the characterization of the income could reduce the long-term yield of the fund and, by doing so, contravene the intent of the donors who contributed to the fund.

The Drafting Committee debated at length whether to include a presumption of imprudence for spending above a fixed percentage of the value of the fund. The Drafting

Committee decided to include a presumption in the Act in brackets, as an option for states to consider, ~~but wanted~~ and to include in these Comments ~~to include~~ a discussion of the advantages and disadvantages of including a presumption in the Act.

Some who commented on the Act viewed the presumption as linked to the retroactive application of the rule of construction of subsection (c). Donors who contributed to endowment funds under UMIFA (1972) may have assumed that the historic dollar value of their gifts would be subject to a no-spending rule under the statute. ~~UMIFA~~UPMIFA ~~(200)~~ deletes the concept of historic dollar value, and the presumption of imprudence may serve to assure donors that spending from an endowment fund will be limited.

Those in favor of the presumption of imprudence argued that the presumption will curb the temptation a charity might have to spend endowment assets too rapidly. Although the presumption would be rebuttable, and spending above the identified percentage might, in some years and for some charities, be prudent, institutions will likely be reluctant to authorize spending above seven percent. In addition, the presumption will give the attorney general guidance in enforcing the prudence standard.

The Drafting Committee also heard arguments against including a presumption of imprudence in the statute. A fixed percentage in the statute might be perceived as a safe harbor and could lead institutions to spend more than is prudent. Although the provision should not imply that spending below seven percent will be considered prudent, some charities might interpret the statute in that way. Decision makers might be pressured to spend more than is prudent, or might be willing to make spending decisions without adequate analysis.

Perhaps the biggest problem with including a presumption in the statute is the difficulty of picking a number that will be appropriate given the range of institutions and charitable purposes and the fact that economic conditions will change over time. Under current economic conditions, a spending rate of seven percent is too high for most funds, but in a period of high inflation, seven percent might be too low. In making a prudent decision as to how much to spend from an endowment fund, each institution must consider a variety of factors, including the particular purposes of the fund, the wishes of the donors, changing economic factors, and whether the fund will receive future donations.

Each enacting state should make its own determination as to whether to include the presumption when the state enacts ~~UMIFA~~UPMIFA ~~(200)~~. And whether or not a statute includes the presumption, governing boards must remember that prudence controls decision making. Each governing board must make decisions on expenditures based on the circumstances of the particular charity.

Rebuttable Presumption of Imprudence. Although prudence will dictate the amount an institution should spend, a state may choose to adopt subsection (d) as part of UPMIFA. Subsection (d) creates a rebuttable presumption of imprudence if expenditures in one year exceed seven percent of the assets of an endowment fund. The subsection applies a three-year rolling average in determining the value of the fund for purposes of calculating the seven-percent amount. Endowment spending will rarely exceed seven percent, but an institution can rebut the presumption of imprudence if circumstances in a particular year make expenditures above that amount prudent. The concept and the language for the presumption of imprudence comes from Mass. Gen. L. ch. 180A, § 2 (2004). Massachusetts enacted this rule in 1975 as part of its UMIFA statute. New Mexico adopted the same presumption in 1978. N.M.S.A. § 46-9-2 (C) (2004). The language has been modified slightly to clarify that the three-year period consists of the three years immediately preceding the year of the expenditure.

If sufficient evidence establishes, by a preponderance of the evidence, the facts necessary to raise the presumption of imprudence, then the institution will have a burden of production of going forward with evidence to meet or rebut the presumption. The existence of the presumption does not shift the burden of persuasion to the charity. [more needed here]

The Drafting Committee discussed the fact that expenditures from an endowment fund may include distributions for charitable purposes and ~~,~~amounts used for the management and administration of the fund, including ~~and the costs of~~ annual charges for fundraising ~~for the fund.~~. The value of a fund, as calculated for purposes of determining the seven percent amount, will reflect increases due to contributions and investment gains and decreases due to distributions and investment losses. The seven percent determination includes annual charges for fundraising and administrative expenses other than investment management expenses. All costs or fees associated with an endowment fund ~~Amounts used to pay fund expenses will be deducted from the fund before the institution computes seven percent of the fund's value. Thus the seven percent will be applied to the net value of the fund and administrative expenses will not be included in computing the expenditures from the fund. However, the costs of administration and fundraising~~ are factors that prudent decision makers consider. ~~Thus, high~~ High costs or fees of investment management could be considered imprudent~~,~~ regardless of whether ~~total~~ spending exceeds seven percent of the fund's value.

The presumption of imprudence does not create an automatic safe harbor. Expenditures at six percent might well be imprudently high. [add discussion of James P. Garland, *The Fecundity of Endowments and Long-Duration Trusts*, The Journal of Portfolio Management (2005).] Indeed, evidence discussed by the Drafting Committee suggests that few funds can sustain spending at a rate above five percent. *See* Roger G. Ibbotson & Rex A. Sinquefield, Stocks, Bonds, Bills, and Inflation: Historical Returns (1926-1987) (Research Foundation of the Institute of Chartered Financial Analysts, 1989 [cite to newer version]). Further, spending at a lower rate, particularly in the early years of an endowment, may result in greater distributions over time. *See* DeMarche Associates, Inc, Spending Policies and Investment Planning for Foundations: A Structure for Determining a Foundation's Asset Mix (Council on Foundations: 3d ed. 1999). A presumption of imprudence can serve as a reminder that spending at too high a rate will jeopardize the long-term nature of an endowment fund. If an endowment fund is intended to continue indefinitely, the institution should take special care to limit annual spending to a level that protects the purchasing power of the fund.

For a discussion of spending approaches, see Joel C. Dobris, *New Forms of Private Trusts for the Twenty-First Century—Principal and Income*, 31 Real. Prop., Prob. & Tr. J. 1

(1996). For example, Dobris suggests that spending 5% or 4% of a five-year moving average of 11 market values might be appropriate. *Id.*, at 39. [change cite to more recent Dobris article]

The presumption of imprudence indicates that the terms of the gift instrument can provide additional spending authority. For example, if a gift instrument directs that an institution expend a fund over a ten-year period, exhausting the fund after ten years, spending at a rate higher than seven percent will be necessary. The section does not require an institution to spend a minimum amount each year because the prudence standard and the needs of the institution will be sufficient guidance as to whether accumulation rather than spending might be appropriate in a particular year.

Spending above seven percent in any one year will not necessarily be imprudent. For some endowment funds fluctuating spending rates may be appropriate. Although the Act does not apply the percentage for the presumption on a rolling basis (e.g., 21 percent over three years), some endowment funds may prudently spend little or nothing in some years and more than seven percent in other years.

For example, a charity planning a construction project might decide to spend nothing from an endowment for three years and then in the fourth year might spend 20 percent of the value of the fund for construction costs. The decision to accumulate in years one through three and then to spend 20 percent in year four might be prudent for the charity, depending on the other factors. The charity should maintain adequate records during the accumulation period and should document the decision-making process in year four to be able to meet the burden of production associated with the presumption.

Another charity might establish a “capital replacement fund” designed to provide funds to the institution for repair or replacement of major items of equipment. Disbursements from this kind of fund will likely fluctuate, with limited expenditures in some years and then big expenditures when the charity needs new equipment. The fund would not operate under a relatively uniform spending rate. Indeed, an advantage of a capital replacement fund will be its ability to absorb a significant capital expenditure in a single year without a negative impact on the operating budget of the institution. Disbursements might average five percent per year but would vary, with spending in some years more and in some years less. Even if this fund is an endowment fund subject to Section 4, spending above seven percent in a particular year could well be prudent. Subsection (d) does not preclude spending above seven percent.

A charity creating a capital replacement fund or a building fund might chose to adopt spending rules for the fund that would not be subject to ~~UMIFA~~UPMIFA ~~(200)~~. Specific donor intent can supersede the rules of ~~UMIFA~~UPMIFA. If the charity creates a gift instrument that establishes appropriate rules on spending for the fund, and if donors agree to those restrictions, then the ~~UMIFA~~UPMIFA rules on spending, including the presumption, will not apply.

[SECTION 5. DELEGATION OF MANAGEMENT AND INVESTMENT FUNCTIONS.

(a) Subject to any specific limitation set forth in a gift instrument or in law other than this [act], an institution may delegate to an external agent the management and investment of an institutional fund to the extent that an institution could prudently delegate under the circumstances. An 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 an agent;

(2) establishing the scope and terms of the delegation, consistent with the purposes of the institution and the institutional fund; and

(3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the scope and terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the institution to exercise reasonable care to comply with the scope and terms of the delegation.

(c) An institution that complies with subsection (a) is not liable for the decisions or actions of an agent to which the function was delegated.

(d) By accepting delegation of a management or investment function from an institution that is subject to the laws of this state, an agent submits to the jurisdiction of the courts of this state in all proceedings arising from the delegation.

(e) An institution may delegate <u>management and investment functions to the</u> ~~to~~ committees, officers, or employees of the institution as authorized by law other than this [act].]

Preliminary Comment

The prudent investor standard in Section 4 depends on the power to delegate. For many investment forms, prudence dictates diversification and diversification may best be accomplished through pooling investment vehicles which require delegation. The Drafting Committee decided to put Section 5 in brackets because many states may already provide delegation authority through other statutes. If other delegation authority exists, then an enacting state should enact ~~UMIFA~~UPMIFA ~~(200-)~~ without Section 5. Enacting delegation rules that duplicate existing rules could be confusing and could potentially create conflicts. For charitable trusts, UPIA provides the same delegation rules as those in Section 5. For nonprofit corporations, nonprofit corporation statutes may provide these rules. A state enacting ~~UMIFA~~UPMIFA ~~(200-)~~ must be certain that its laws authorize delegation, either through other statutes or by enacting Section 5.

Section 5 incorporates the delegation rule found in UPIA § 9, updating the delegation rules in UMIFA (1972) § 5. Section 5 permits the decision makers in an institution to delegate management and investment functions to external agents if the decision makers exercise reasonable skill, care, and caution in selecting the agent, defining the scope of the delegation and reviewing the performance of the agent. Decision makers cannot delegate the authority to make decisions concerning expenditures and can only delegate management and investment functions. Subsection (c) protects decision makers who comply with the requirement for proper delegation from liability for actions or decisions of the agents.

Section 5 does not address issues of internal delegation and potential liability for internal delegation, and subsection (c) does not affect laws that govern personal liability of directors or trustees for matters outside the scope of Section 5. Directors will look to nonprofit corporation laws for these rules, while trustees will look to trust law. *See, e.g.*, RMNCA, § 8.30(b) (permitting directors to rely on information prepared by an officer or employee of the institution if the director reasonably believes the officer or employee to be reliable and competent in the matters presented).

The language of subsection (c) is similar to that of UPIA § 9(c) and RMNCA § 8.30(d). The decision not to include the terms “beneficiaries” or “members” in subsection (c) does not indicate a decision that this section does not create immunity from claims brought by beneficiaries or members. Instead, a decision maker who complies with section 5 will be protected from any liability resulting from actions or decisions made by an external agent.

Subsection (d) creates personal jurisdiction over the agent. This subsection is not a choice of law rule.

Subsection (e) notes that law other than this Act governs internal delegation. Section 5 of UMIFA (1972) included internal delegation as well as external delegation, due to a concern at that time that trust law concepts might govern internal delegation in nonprofit corporations. With the widespread adoption of nonprofit corporation statutes, that concern no longer exists. The decision not to address internal delegation in ~~UMIFA~~UPMIFA ~~(200-)~~ does not suggest that a governing board of a nonprofit corporation cannot delegate to committees, officers, or employees. Rather, a nonprofit corporation must look to other law, typically a nonprofit corporation statute, for the rules governing internal delegation.

SECTION 6. RELEASE OR MODIFICATION OF RESTRICTIONS ON MANAGEMENT, INVESTMENT, OR PURPOSE.

~~(a) In this section, "institutional fund" includes each fund of two or more institutional funds collectively managed.~~

~~(b)~~ (a) With the donor's consent in a record, an institution may release, in whole or in part, a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund. A release may not allow a fund to be used for a purpose other than a charitable purpose of the institution.

~~(c)~~ (b) If, because of circumstances not anticipated by the donor, a modification will further the purposes of the institutional fund, or a restriction becomes impracticable or wasteful and impairs the management or investment of the fund, the court, upon application of an institution, may modify a restriction contained in a gift instrument on the management or investment of an institutional fund. The institution shall notify the [Attorney General], who must be given an opportunity to be heard. To the extent practicable, any modification must be made in accordance with the donor's probable intention.

~~(d)~~ (c) If a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund becomes unlawful, impracticable, impossible to achieve, or wasteful, the court, upon application of an institution, may modify the purpose of the fund or the restriction on the use of the fund in a manner consistent with the charitable purposes expressed in the gift instrument. The institution shall notify the [Attorney General], who must be given an opportunity to be heard.

~~(e)~~ (d) If an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution, [60 days] after notification to the [Attorney General], may release or modify the restriction, in whole or part, if:

(1) the institutional fund subject to the restriction has a total value of less than [$25,000];

(2) more than [20] years have elapsed since the fund was established; and

(3) the institution uses the property in a manner the institution determines, in good faith, to be consistent with the charitable purposes expressed in the gift instrument.

Preliminary Comment

Section 6 expands the rules on releasing or modifying restrictions that are found in Section 7 of UMIFA (1972). Subsection (b) restates the rule from UMIFA (1972) allowing the release of a restriction with donor consent. Subsections (c) and (d) make clear that an institution can always ask a court to apply equitable deviation or cy pres to modify or release a restriction, under certain circumstances. Subsection (e), a new provision, permits an institution to apply cy pres on its own for small funds that have existed for a substantial period of time, after giving notice to the state attorney general.

~~Subsection (a).~~ Individual Funds. The rules on modification require that the institution, or a court applying a court-ordered doctrine, review each institutional fund separately. Although ~~the term institutional~~ an institution may manage institutional funds collectively, ~~can mean more than one fund for other purposes of the Act,~~ for purposes of this Section, each fund must be considered individually.

Subsection ~~(b)~~ (a). Donor Release. Subsection ~~(b)~~ (a) permits the release of a restriction if the donor consents. A release with donor consent cannot change the charitable beneficiary of the fund. Although the donor has the power to consent to a release of a restriction, this section does not create a power in the donor that will cause a federal tax problem for the donor. The gift to the institution is a completed gift for tax purposes, the property cannot be diverted from the charitable beneficiary, and the donor cannot redirect the property to another use by the charity. The donor has no retained interest in the fund.

Subsection ~~(c)~~ (b). Equitable Deviation. Subsection ~~(c)~~ (b) applies the rule of equitable deviation, modifying the language from UTC § 412 for application in this section. *See also* Restatement (Third) of Trusts § 66 (2003). Under deviation, a court modifies restrictions on the way an institution manages or administers a fund, doing so in a manner that furthers the purposes of the fund. Deviation implements the donor's intent. A donor may have a predominate purpose for a gift and, secondarily, an intent that the purpose be carried out in a particular manner. Deviation does not alter the purpose but rather modifies the means of carrying out the purpose.

Sometimes deviation is needed due to circumstances unanticipated when the donor created a restriction on a gift. In other situations a restriction may impair the management or investment of the fund. Modification of the restriction may permit the institution to carry out the donor's purposes in a more effective manner. A court applying deviation should attempt to follow the donor's probable intention in deciding how to modify the restriction. Consistent with the doctrine of equitable deviation, subsection ~~(c)~~ (b) does not require an institution to notify donors of the proposed modification. Good practice dictates notifying any donors who are alive and can be located with a reasonable expenditure of time and money.

Subsection ~~(d)~~ (c). Cy Pres. ~~A court can modify the purpose of an institutional fund using the doctrine of cy pres.~~ Subsection (c) applies the rule of cy pres from trust law. Under ~~subsection (d)~~cy pres a court can modify the purpose of an institutional fund, and the focus of cy pres is on the purpose of the fund rather than on the means of carrying out the purpose. The term "modify" encompasses the release of a restriction as well as an alteration of a restriction and also permits a court to order that the fund be paid to another institution. A court can apply the doctrine of cy pres only if the restriction in question has become unlawful, impracticable, impossible to achieve, or wasteful. This standard, which comes from UTC § 413, updates the circumstances under which cy pres may be applied by adding "wasteful" to the usual common law articulation of the doctrine. Any change must be made in a manner consistent with the charitable purposes expressed in the gift instrument. *See also* Restatement (Third) of Trusts § 67 (2003).

Subsection ~~(d)~~ (c) is intended make the case law under cy pres applicable to institutions covered by UMIFA ~~(200)~~ and does not limit the doctrine of cy pres. In addition to requesting that a court apply cy pres to modify a restriction, an institution may seek court assistance otherwise, for example by requesting the dissolution of the institution. Consistent with the doctrine of cy pres, subsection ~~(d)~~ (c) does not require an institution seeking cy pres to notify donors. Good practice will be to notify donors when possible.

Subsection ~~(e)~~ (d). Modification of Small, Old Funds. Subsection ~~(e)~~ (d) permits an institution to release or modify a restriction using a cy pres approach but without court approval if the amount of the institutional fund involved is small and if the institutional fund has been in existence for more than 20 years. The Drafting Committee determined that under some circumstances a restriction may no longer make sense but the cost of a judicial cy pres proceeding will be too great to warrant a change in the restriction. The Committee discussed at length the parameters for allowing an institution to apply cy pres itself, without court supervision. The Committee drafted subsection ~~(e)~~ (d) to balance the needs of an institution to operate efficiently for its charitable purposes and the need to protect donors' wishes. The subsection assumes that an institutional fund with a value of $25,000 or less is sufficiently small that the cost of a judicial proceeding will be out of proportion with the need to change the restriction. The Committee included a requirement that the institutional fund be in existence at least 20 years because it seemed reasonable to require additional safeguards for donors' intent for some period of time after the creation of the institutional fund. The 20-year period begins to run from the date of inception of the fund and not from the date of each gift to the fund. The amount and the number of years have been placed in brackets to signal to enacting jurisdictions that they may wish to designate a higher or lower figure.

As under judicial cy pres, an institution acting under subsection ~~(e)~~ (d) must change the restriction in a manner that is in keeping with the intent of the donor and the purpose of the fund. For example, if the value of a fund is too small to justify the cost of administration of the fund as a separate fund, the term "wasteful" would allow the institution to combine the fund with another fund with similar purposes. If a fund had been created for nursing scholarships and the institution closed its nursing school, the institution might appropriately decide to use the fund for other scholarships at the institution. In using the authority granted under subsection ~~(e)~~ (d), the institution must make a good faith determination of which alternative use for the fund reasonably approximates the original intent of the donor. The institution cannot divert the fund to an entirely different use. For example, the fund for nursing scholarships could not be used to build a football stadium.

Notice to Donors. The Drafting Committee decided not to require notification of donors under subsections (b), (c), and (d). The trust law rules of equitable deviation and cy pres do not require donor notification and instead depend on the court and the attorney general to protect donor intent and the public's interest in charitable assets. The Drafting Committee concluded that subsections (b) and (c) should be consistent with the trust law doctrines of equitable deviation and cy pres, both so that institutions would not be governed by two conflicting sets of rules and because the trust rules are appropriate. Further, because donors do not have standing to bring suit against an institution, providing notice to donors would have limited utility. Of course, good practice will always be to notify donors who can be identified of any possible change that might affect the donors' gifts to an institution. Institutions will be concerned with maintaining good donor relations, and thus have a strong incentive to notify donors whenever possible.

The Drafting Committee also concluded that subsection (d) should not require an institution to give notice to donors. ~~an institution acting under subsection (e) to give notice to the donors who had contributed to the fund.~~ Subsection ~~(e)~~ (d) can only be used for an old and small fund. For such a fund, locating a donor who contributed to the fund more than 20 years earlier may be difficult and expensive. Locating multiple donors, each of whom gave a small amount to create a fund 20 years earlier, may be even more expensive. For any old fund, notice by publication is not likely to be effective in providing actual notice to the donors. ~~Good~~ Again, good practice dictates notifying known donors of any change considered by the institution. The Drafting Committee concluded that an institution's concern for donor relations would serve as a sufficient incentive for following that practice when donors can be located. For example, an institution that received a gift from a private foundation or a single donor will probably be able to contact the foundation or donor, even 20 or more years after the gift. In other circumstances, the attorney general can protect the interests of the donors and the public.

SECTION 7. REVIEWING COMPLIANCE. Compliance with this [act] is determined in light of the facts and circumstances existing at the time a decision is made or action is taken, and not by hindsight.

SECTION 8. APPLICATION TO EXISTING INSTITUTIONAL FUNDS. This [act] applies to institutional funds existing on or established after the effective date of this [act]. As applied to institutional funds existing on its effective date, this [act] governs only decisions made or actions taken after that date.

SECTION 9. RELATION TO ELECTRONIC SIGNATURES IN GLOBAL AND NATIONAL COMMERCE ACT. This [act] modifies, limits, and supersedes the federal Electronic Signatures in Global and National Commerce Act (15 U.S.C. Section 7001 et seq.) but does not modify, limit, or supersede Section 101 of that act (15 U.S.C. Section 7001(a)) or authorize electronic delivery of any of the notices described in Section 103 of that act (15 U.S.C. Section 7003(b)).

SECTION 10. UNIFORMITY OF APPLICATION AND CONSTRUCTION. In applying and construing this Uniform Act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among states that enact it.

SECTION 11. EFFECTIVE DATE. This [act] takes effect . . . .

SECTION 12. REPEAL. The following acts and parts of acts are repealed:

(a) [The Uniform Management of Institutional Funds Act]