

Memorandum

To: Drafting Committee and Observers

From: Susan Gary

Re: UMIFA – new draft, continuing issues

Date: August 25, 2004

The next Drafting Committee meeting will be December 3-5, 2004, in Chicago.

Attached is the current draft of UMIFA (200-) (referred to simply as UMIFA in this memo). At the Drafting Committee meeting that immediately preceded the reading of UMIFA at the Annual Meeting of NCCUSL, the Drafting Committee made a number of stylistic and structural changes to the Act. Of particular interest are changes to Sections 3 and 4 to make the language in the two sections consistent and to follow more closely the language used in the Revised Model Nonprofit Corporation Act. We determined that using different formulations of the standards was unnecessarily confusing.

The Drafting Committee decided to ask the Commission to delay a final decision on UMIFA for a year to allow us to gather more input from interested groups. Two significant issues remain.

Structuring UMIFA to Cover Trusts

The Drafting Committee thinks that rules concerning the investment and management of charitable funds, rules concerning the spending of endowment funds, and rules governing the modification of restrictions on charitable funds, should not depend on the organizational structure of the charity. The legal rules should be consistent for charities organized as nonprofit corporations, charitable trusts, unincorporated associations, and limited liability companies, and for charities organized in any other manner. The Drafting Committee remains somewhat uncertain about the best way to accomplish this goal.

Several of the sections of UMIFA already apply to charitable trusts, at least in states that have enacted the Uniform Prudent Investor Act and the Uniform Principal and Income Act. The fact that not all states have adopted both of those Acts is a reason to configure UMIFA as the current draft does, applying all provisions of UMIFA to all charities. An alternative approach is to apply to charitable trusts only those sections of UMIFA that do not already apply to charitable trusts through Prudent Investor or Principal and Income. That would mean restructuring the Act to apply to charitable trusts only Section 4 (Expenditure of Endowment Funds; Rule of Construction), and subsections (b) and (d) of Section 6 (Release or Modification of Restrictions on Use or Investment. Subsection (b) permits a charity to release a restriction with the consent of a

donor, and subsection (d) permits a charity to modify a restriction, using a cy pres approach but without court supervision, if the fund involved is old and small.)

The two most likely approaches are (1) the Act as drafted and (2) a two-part Act, with one part applicable to charities created in any manner other than as a charitable trust and one part applicable to charitable trusts. The part applicable to charitable trusts would contain only the rules on endowment spending and the rules on modification of restriction that are not available under the Uniform Trust Code.

The Prudence Standard, Historic Dollar Value, Presumptions

The Drafting Committee continues to think that requiring charities to make endowment spending decisions subject to a prudence standard, as set forth in Section 4 of the current draft, will result in the best outcomes for charities and their donors. A donor can choose, with the agreement of the donee charity, to restrict spending from a particular fund. However, if the donor instructs the charity to “hold the gift and pay out the income,” the instruction indicates the donor’s intent to create a fund of indefinite duration that will be used to provide current and continuing support for the charity’s activities. The charity will make spending decisions guided by the donor’s intent that the spending power of the fund be preserved and based on economic conditions, investment success, and the purposes of the fund. As they have under UMIFA (1972), charities will develop spending policies that will smooth out the ups and downs of their investments, while maintaining the value of the fund. The Act does not tell governing boards how much to spend, recognizing that charities come in many sizes and that their funds have many purposes.

A number of those commenting on the Act continue to be concerned that without greater guidance in the Act, charities will be tempted to spend more than is prudent. The Drafting Committee has also heard the concern that attorneys general will have difficulty regulating imprudent spending without a bright-line rule. Spending guidance could come in three forms.

Historic Dollar Value

A few people have advocated that the Act continue to incorporate the concept of historic dollar value (“hdv”). UMIFA (1972) says that a board can spend from endowment funds the amount that is prudent, but the board cannot spend appreciation if the fund drops below its “historic dollar value,” the amount actually contributed to the fund. The hdv concept is flawed in many respects. First, hdv is not adjusted for inflation. Thus, hdv does not force the preservation of the real value of a fund but only an historic value. For most old funds, hdv is meaningless. In thinking about the appropriateness of the prudence standard, it is useful to note that most old charities have not spent down to hdv. Instead, charities have been guided by UMIFA (1972) to spend prudently and have developed spending rules that maintain the real value of their endowment funds.

Recently, some charities have been faced with funds with values dramatically below hdv. If a contribution arrived when the stock market was high and then the stock market dropped significantly, the fund may have dropped below hdv and may stay below hdv for a long time. Although some people commenting on the hdv issue have expressed the view that donors intend that hdv remain inviolate, one lawyer wrote that several of her clients wanted spending to invade hdv. She commented:

I spoke to several donors last year to explain why the charity client could not spend from their respective funds (underwater or no income built up yet) and every one of them wanted the programs to start so authorized spending through the historic dollar value limit.

Harvey Dale, University Professor of Philanthropy and the Law at New York University and Director of the National Center on Philanthropy and the Law, writes about hdv as follows:

I favor elimination of historic dollar value. HDV is fatally flawed because it is neither a function of the passage of time nor a function of the return on investments. Thus, it departs from reality immediately and generally moves ever further away from it. I sympathize with the urge to tether a rule to a fixed point, but any chosen tethering point should have some likelihood of approximating reality. HDV fails that test. We should take courage, however, in the fact that reasonable people — investors, regulators, and judges — can exercise good judgment and be held accountable for bad judgment.

Rebuttable Presumption of Imprudence

An alternative approach is to include in the Act a rebuttable presumption that spending in excess of seven percent of the value of the endowment fund, calculated on a three year rolling basis, is imprudent. Massachusetts takes this approach. The provision does not say that spending below seven percent is presumed prudent, but some charities may read this provision as saying that spending at six percent is ok. Of course, most charities cannot sustain spending at six percent, so the risk of a rebuttable presumption of imprudence is that it will encourage charities to spend more than they should.

Rebuttable Presumption of Prudence

A third approach is to include in the Act a rebuttable presumption of prudence if a charity spends between two percent and seven percent each year. Pennsylvania takes this approach. Although a presumption of prudence will guide governing boards and give them a sense of comfort in making spending decisions, such a provision is even more likely that the rebuttable presumption of imprudence to encourage spending at a level higher than is prudent. If the statute says that spending at six percent or seven percent is rebuttably prudent, anyone arguing that spending at that level was imprudent will have a difficult time. For most charities, a long-term spending rate of seven percent will likely result in reductions in the real value of their endowments.

Given the range of charities and charitable purposes and the uncertainties in investments, setting any kind of spending rule in UMIFA, even a presumptive one, appears problematic. At the same time, imprudent spending is a very real concern. Determining the best way to address this issue continues to be at the forefront of the discussions of the Drafting Committee.

Retroactive Application

The Drafting Committee has received a few comments suggesting concern that if UMIFA applies to gifts made prior to the effective date of the Act, donor intent will be thwarted. The concern expressed is that a donor making a gift prior to the enactment of a new UMIFA will know and depend on UMIFA (1972)'s historic dollar value concept. While this may be true for some donors, the comment from the lawyer whose clients were surprised and unhappy to learn about hdv suggests that not all donors know or care about hdv. In the view of the Drafting Committee, donors care most that a charity will maintain the purchasing power of an endowment fund, will make distributions each year for the purposes of the charity, and will continue to grow the fund so that it will last indefinitely.

Determining actual donor intent for all donors is impossible, and any discussion of donor intent is necessarily hypothetical, except with respect to a few specific cases. More important is to create a statute that will carry out the intent of most donors and that will enable a charity to operate efficiently. Just as most donors would not intend an endowment fund to be spent down quickly -- which UMIFA does not encourage and in most if not all cases does not permit -- most donors probably do not expect that a charity will be unable to spend anything from an endowment fund. UMIFA presents a reasonable construction of what most donors intend when making a gift to "an endowment."

From a practical standpoint, applying UMIFA prospectively will have detrimental consequences for charities. A charity with pre-UMIFA funds and post-UMIFA funds would have to continue to track hdv for the pre-UMIFA funds. A small charity with one endowment fund would have to create a second fund to hold post-UMIFA funds. For charities organized as trusts, the difficulties would be even greater. Those charities would not have been subject to UMIFA (1972) and would apply UMIFA spending rules to post-UMIFA gifts only.

Gathering More Feedback

I will send this memo and the new draft to all those who have expressed interest in this project. I encourage all of you to submit comments to me, electronically if possible. My email address is sgary@law.uoregon.edu. The Reporter's Comments continue to evolve, and I also seek suggestions or questions about the Comments.