

## UMIFA Becomes UPMIFA <sup>1</sup>

By Susan Gary <sup>2</sup>

The Uniform Management of Institutional Funds Act (UMIFA) guides charities on the management and investment of funds, provides rules on spending from endowment funds, and permits the release of restrictions on the use and management of charitable funds. The Act has been adopted in 47 states and the District of Columbia. It has been successful, but portions of it are out-of-date, and the National Conference of Commissioners on Uniform State Laws (the Uniform Law Commission) at its annual meeting on July 13, 2006, approved a revised version: the Uniform Prudent Management of Institutional Funds Act (UPMIFA).

In 1972, when the Uniform Law Commission promulgated UMIFA, a great deal of uncertainty existed about the standards that governed directors of charities operating as nonprofit corporations. Trust law provided guidance, but trust law at that time restricted investment decision making in a number of ways. Trustees analyzed risk on an asset-by-asset basis, rather than across the portfolio. Trust law did not permit delegation of investment authority, so involving investment advisors caused concern. Trust accounting rules defined income and principal in a way that affected both spending and investing. If a charity could spend only "income" under trust law rules, the trust law definition of income limited investment options. UMIFA created a new set of rules that made total-return investing possible for charities organized as nonprofit corporations.

In the period since 1972, trust law has caught up with UMIFA in many respects. The Uniform Prudent Investor Act (UPIA), a trust law statute now adopted in 44 states, provides modern guidance for the prudence standard fiduciaries should follow in making investment decisions. Although the comments to UPIA suggest that the standards articulated in that statute also apply to charities organized as nonprofit corporations, making the standard explicitly applicable to all charities makes sense. With this and other changes in mind, the Uniform Law Commission decided to update UMIFA.

Four years in the making, UPMIFA updates the prudence standard that applies to the management and investment of charitable funds. UPMIFA also modernizes the rules governing expenditures from endowment funds, both to provide better guidance on spending from

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endowment funds and to give institutions the ability to cope more easily with fluctuations in the value of the endowment. Finally, UPMIFA adopts provisions governing the release and modification of restrictions on charitable funds to permit more efficient management of these funds. UPMIFA applies, as did UMIFA, to charities organized as nonprofit corporations and to charities organized as trusts, but only to those trusts that have a charity as a trustee.

## **Prudent Investing**

The standard for investing and managing charitable funds is one of prudence. Although the law applicable to private trusts and to business corporations may hold trustees and directors to different standards of care, the standard of care for those managing a charity should be the same for all charities, regardless of the organizational form.

UPMIFA's articulation of the prudence standard reflects the merging of the trust and corporate standards when applied to managers of charitable funds. The statute takes language from both the Revised Model Nonprofit Corporation Act (RMNCA) and UPIA. The RMNCA states that a manager must act "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." This language derives from the business standard, but "similar circumstances" refers to the fact that the funds are managed for charitable purposes and not business purposes. UPMIFA uses language from the RMNCA and then follows this general direction with specific factors that a manager should consider. These factors derive from UPIA and are consistent with good practice under current law.

The prudence standard in UPMIFA requires managers to meet their fiduciary duty of care, the duty to minimize costs, and the duty to investigate with respect to investment decision making. In addition, UPMIFA directs managers of charities to consider general economic conditions, to make decisions on a portfolio basis, to allocate risk and return across the portfolio, and to consider the needs of the charity both to make distributions and to preserve capital. A charity can pool funds for purposes of management and investment, and in some situations doing so can yield better investment results. Managers are reminded that donor intent controls, so a charity must follow any specific donor directions for investment and management of assets. Of course, this emphasis on donor intent does not mean that a donor should control the management of a charity.

Prudence is a standard that evolves over time, and UPMIFA is simply updating the statutory language to provide good direction about the role of prudence in investment and management. The guidance should be helpful to charities and comports with current best practices.

## **Endowment Spending**

The big change UPMIFA brings comes in the rules on spending from endowment funds, defined as funds that cannot be wholly expended on a current basis. These rules apply to donor-restricted funds and not to board-restricted funds. Money set aside by a board of directors as an "endowment" is a board-restricted fund; money contributed by a donor with the intent that the money be held as an endowment is a donor-restricted fund. If a charity raises money for its



endowment, and donors contribute with the understanding that the charity will hold their contributions in the endowment, then these rules apply to that fund. Donor intent in this regard will depend on the applicable "gift instrument," the documents that define the terms of the gift. The gift instrument may be a letter from the donor accompanying the gift, a solicitation from the charity to which the donor responds, or a gift agreement entered into by the donor and the charity.

UMIFA's spending rule has been critically important to the successful functioning of the investment guidance the statute provides. Endowments are typically described as funds that maintain principal and distribute income. The difficulty lies in determining what constitutes principal and income. Before UMIFA arrived on the scene, charities organized as nonprofit corporations assumed that trust accounting rules applied to them. Those rules defined income to exclude capital gains. Thus, a direction to "spend only income" meant that a charity might skew its investment decisions to produce more trust accounting income, to the detriment of the long-term health of a fund.

Rather than trying to define income and principal, the drafters of UMIFA devised a spending rule that seemed a better fit for charities. UMIFA uses the term historic dollar value (HDV) to mean the value of contributions made to an endowment fund, without increases or decreases because of investment results, inflation, or anything else. Under UMIFA, a charity can spend from an endowment fund the amount of appreciation above HDV the charity deems prudent, after considering the charity's purposes, but can never spend below HDV. The prudence standard in UMIFA limits spending above HDV because a charity can spend only the amounts the directors determine to be prudent. The statute provides minimal guidance, however, and focuses on the needs of the charity rather than on the purpose of the particular fund. Fortunately, despite the limited statutory guidance, most charities have developed spending rules that comply with UMIFA and also limit spending in ways that preserve the purchasing power of the endowment funds they manage.

UPMIFA no longer uses the term "historic dollar value" and no longer restricts spending to amounts above HDV. Under UPMIFA, a charity can spend the amount the charity deems prudent after considering the donor's intent that the endowment fund continue permanently, the purposes of the fund (and not just of the charity as under UMIFA), and relevant economic factors. The intention of the change is not to permit unrestricted spending from an endowment fund. UPMIFA applies a more carefully articulated prudence standard than that used in UMIFA to guide the process of making decisions about spending. UPMIFA emphasizes the perpetuation of the purchasing power of the fund, not just of the original dollars contributed to the fund. Although the Act does not require that a specified amount be set aside as principal, the Act assumes that a charity will preserve "principal" by maintaining the purchasing power of amounts contributed and will spend "income" by making a distribution each year using a reasonable spending rate. UPMIFA encourages charities to establish a spending policy that will be responsive to short-term fluctuations in the value of the fund.



# UPMIFA

*uniform prudent management of institutional funds act*

Any donor restrictions agreed to by a charity will control the management of an endowment fund. If a donor wants to create an endowment fund that can spend only 4% each year, and if the charity agrees to the restriction, the restriction will govern spending from the fund. If, however, the donor restricts the fund by indicating that the charity should "pay only income" or "hold the fund as an endowment," then a rule of construction in UPMIFA will treat the fund as an endowment fund subject to the UPMIFA rules on spending. The Act assumes that a donor who gives to an endowment fund wants the charity to use modern investment strategies to generate enough funds to distribute while maintaining the long-term viability of the fund. UPMIFA gives effect to the presumed intent of the donor.

UPMIFA will apply to charitable funds created both before and after enactment. Some people have expressed concern that the change in the endowment spending rules will affect donor intent. The rule of construction in UPMIFA gives meaning to a donor's direction to "pay only the income" from an endowment. A constructional rule resolves an ambiguity, in this case because the words used by a donor do not convey a specific meaning. Changing a statutory constructional rule does not change the underlying intent and, instead, changes the way an ambiguity is resolved. The change should better effectuate the intent of the donors. The committee that drafted UPMIFA concluded that the new rules provide better protection for donors and for charities. The committee also noted that unless UPMIFA applies retroactively, charities will face unwieldy and costly administrative burdens. Without retroactive application, a charity would have to maintain two sets of records for every endowment fund created before enactment that receives contributions after enactment.

Because of concerns expressed by some constituencies about the removal of HDV as a floor for spending, the committee agreed to draft two optional provisions for legislatures to consider. The Act should function well without these optional provisions, but some states may prefer to include one or both of them. The first optional provision appears in brackets in the text of the Act. The provision, section 4(d), creates a rebuttable presumption of imprudence for spending more than 7% of the value of an endowment fund in one year. The value of the fund is determined based on a three-year rolling average. Seven percent is a high number and is not intended as a safe harbor. The number was made high enough to allow some fluctuation in a year when a charity needs to spend more and to allow for some changes in economic conditions.

Those in favor of the presumption argue that the presumption provides a useful guideline for charities and for those who supervise charities. The presumption may also curb a charity's temptation to spend its endowment funds too quickly. Those opposed to including the presumption express concern that a charity may interpret the provision to mean that spending below 7% is presumed to be prudent, even though the statute provides otherwise. Other arguments against the presumption focus on the difficulty of identifying a percentage that can be appropriate for the range of charities and purposes covered by UPMIFA.

The second optional provision appears in the comments following section 4. This provision targets charities with limited initial investment and spending experience that could benefit from



additional scrutiny by the attorney general. This optional provision states that if a charity with endowment funds valued, in the aggregate, at less than \$2 million, plans to authorize spending that will take the total value of all endowment funds held by the charity below total HDV for those funds, then the charity must notify the attorney general in that state before proceeding. The optional provision gives the attorney general 60 days to take action before the charity spends below HDV but does not require approval from the attorney general. If the attorney general's office gets notice of proposed spending, someone in the office can review the decision, talk with the charity, and provide advice on prudent spending before the charity spends the money.

## **Release or Modification of Restrictions**

A charity can continue indefinitely. Over time, changing circumstances may necessitate changes in the way the charity carries out its purposes or changes in the purposes themselves. UPMIFA provides rules for modification that clarify the ways in which nonprofit corporations can change restrictions.

UPMIFA, like UMIFA, permits a donor to release a restriction the donor imposed on a charitable gift. The donor cannot direct the use of the property after the release, but a charity would likely work with the donor to decide on the appropriate changes.

Under UMIFA, if the charity could not obtain the donor's consent, perhaps because the donor was dead, the charity could ask a court to release a restriction. The problem with this approach is that the statute gives the court authority to release the restriction but appears to give the charity control over the use of the assets after the release, without the application of cy pres principles. Section 7(d) of UMIFA then cryptically notes that the release provision "does not limit the application of the doctrine of cy pres."

Rather than permitting release by a court, with no restrictions on future use, UPMIFA adopts the doctrines of cy pres and deviation from trust law, taking language from the Uniform Trust Code. Deviation, in UPMIFA 5 6(b), allows a charity to ask the court to release or modify a restriction that has become impracticable or wasteful or one that impairs the management or investment of the fund. The same section permits a request to modify a restriction if, because of circumstances not anticipated by the donor, the modification will further the purposes of the fund. Any change must be consistent with the donor's probable intention. Cy pres allows a charity to ask a court to approve a change because a restriction has become unlawful, impracticable, impossible to achieve, or wasteful. Under the application of cy pres, a change must be consistent with the charitable purposes expressed in the document that created the gift.

UPMIFA adds a new provision that should be of help to charities. Section 6(d) provides that if a fund is both old (20 years) and small (\$25,000), then a charity can apply cy pres to the fund to change a restriction, after first giving notice to the attorney general but without obtaining court approval. The charity must wait 60 days before modifying the restriction, to give the attorney general time to take action if the attorney general finds a problem with the proposed modification. This provision addresses the problem that occurs when a restriction on a fund no



# UPMIFA

*uniform prudent management of institutional funds act*

longer makes sense, but the fund is too small to justify the costs of a court proceeding to request deviation or cy pres.

In keeping with the approach taken under trust law for modification using cy pres or deviation, the Act does not require notification of donors. Of course, a charity's self-interest in maintaining good donor relations will encourage contacting any known donors about any need to release or modify a restriction. UPMIFA does not change the general rule that donors do not have standing to bring a court challenge to a charity's actions. UPMIFA maintains the attorney general's traditional role in protecting donor intent and the public's interest in charitable assets.

## **Enactment**

Now that the Uniform Law Commission has approved UPMIFA, legislatures will begin considering enactment. A copy of UPMIFA, including comments that provide additional information, can be found at [www.nccusl.org](http://www.nccusl.org) or obtained by contacting Susan Gary at [sgary@law.uoregon.edu](mailto:sgary@law.uoregon.edu). Prof. Gary is happy to answer questions, hear comments, and help with legislative efforts in connection with UPMIFA.

