Revisions to the Uniform Management of Institutional Funds Act

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Background

The Uniform Management of Institutional Funds Act ("UMIFA") was originally promulgated in 1972. The Act provides guidance on investment authority, permits delegation of authority to independent financial advisors, authorizes the expenditure of appreciation of investment funds, and provides rules for the release of restrictions on the use or investment of funds. UMIFA (1972) applies to charities organized as nonprofit corporations and unincorporated associations but does not apply to charitable trusts managed by a corporate or an individual trustee.

As a Uniform Act, UMIFA (1972) has been highly successful. Forty-seven jurisdictions have enacted UMIFA, and although variations exist, the general principles of UMIFA have been adopted almost universally. UMIFA's approach to endowment management – permitting the expenditure of unrealized appreciation – has enabled fund managers to use modern investment techniques such as total return investing and unitrust-style spending. UMIFA (1972) was, in a sense, a forerunner of the Uniform Prudent Investor Act, an act that regulates the investment responsibilities and authority of trustees of trusts.

Although UMIFA (1972) has been successful, a Study Committee appointed by the National Conference of Commissioners on Uniform State Laws ("NCCUSL") determined that the time had come for a revision. The Drafting Committee began its work on Revised UMIFA in 2002. The Drafting Committee expects to ask for approval of the Act at the July 2005 Annual Meeting of NCCUSL.

What Charities Does Revised UMIFA Cover – Should Trusts Be Included?

The Drafting Committee's preference was to apply Revised UMIFA to all charities, whether organized as nonprofit corporations, charitable trusts or in some other manner. In the Committee's view, the rules for the management, investment and expenditure of charitable funds should not depend on the organizational form of the charity. Structuring Revised UMIFA in this way would have been a change from UMIFA (1972). UMIFA (1972) does not apply to funds managed by trustees that are not themselves charities and thus excludes charitable funds managed by corporate trustees. This exclusion has led charities in some states to go to court to request that they be allowed to apply a spending rule like the one provided under UMIFA (1972).

The Drafting Committee thought that making the UMIFA rules available to all charities would be beneficial, in particular because the rules are primarily default rules and can be used or not used as a charity decides. Some corporate trustees expressed concern, however, about being subject both to UMIFA and to laws that specifically govern trusts. Having two sources of law governing investment decision making raised a question of whether a trustee might be subject to inconsistent standards.

The uniform acts are coordinated so that the standards for investment decision making are the same whether one looks to the Uniform Prudent Investor Act ("UPIA") or to Revised UMIFA. Indeed, part of the charge to the Drafting Committee was to coordinate Revised UMIFA with UPIA and the Uniform Trust Code (the "UTC"). Thus, Section 3, Standard of Conduct in Managing and Investing Institutional Funds, and Section 5, Delegation of Management and Investment Functions, track the language of UPIA. Section 6 of Revised UMIFA incorporates the modification doctrines of deviation and cy pres from the Uniform Trust Code. A state that enacted uniform versions of these statutes would have a well-coordinated body of law, but if a state modified one or more of the statutes before enactment, differences could develop.

The two areas in which Revised UMIFA provides rules that differ from existing trust law are the rule for endowment spending, Section 4, and the modification provision that permits a charity to apply cy pres to small, old funds, without court supervision.

The Drafting Committee considered both the preference indicated by some bank trustees that Revised UMIFA not apply to them and the concern raised by others who wanted the ability to use the spending rule for endowment funds. The Drafting Committee decided to take funds managed by non-charity trustees out of UMIFA – returning to the approach taken in UMIFA (1972) – and then to request that NCCUSL consider amendments to UPIA and the UTC that would add the UMIFA changes to those statutes. By proceeding in this fashion, the benefits of Revised UMIFA would be available to those who chose to use them, but the rules applicable to trusts would be located in the trust law.

What Funds Does Revised UMIFA Cover?

Institutional Funds. As under UMIFA (1972), Revised UMIFA covers all funds held and managed by a charity for its charitable purposes. Most sections of the Act apply to all funds held by a charity, but the rules on endowment spending apply only to funds that meet the definition of an endowment fund under the Act.

Endowment Funds. For purposes of Revised UMIFA, an endowment fund is a fund that is not wholly expendable on a current basis. The intent of the charity and the donor as expressed in the terms of the "gift instrument" used to create the fund determine whether a fund is an endowment fund and determine the duration of the fund. Most endowment funds will have an indefinite duration, but a fund created with the intention that the assets be exhausted within a ten-year period will also be treated as an endowment fund under the Act.

What Does Revised UMIFA Not Cover?

Program-related Assets. Revised UMIFA excludes assets held primarily for program-related purposes. The Act provides that if an asset held for investment purposes also has a program-related purpose, the decision makers can consider that program-related purpose in making an investment decision.

Other Legal Issues. UMIFA is not a comprehensive statute addressing all legal issues that apply to charitable organizations. UMIFA governs the investment and management of charitable funds, the spending of endowment funds, and the modification of restrictions on charitable funds. Those who govern charities will continue to look to other laws for guidance on other governance issues. Charities organized as nonprofit corporations will be governed by the laws applicable to nonprofit corporations, including any nonprofit corporation statute, and charities organized as charitable trusts will be governed by trust law, both the common law and any statutory law.

Standard for Investing and Managing Institutional Funds - Prudence

Section 3 of Revised UMIFA adopts the prudence standard for managing and investing funds held by charities. Those responsible for managing charitable funds must invest the funds as a prudent investor would. The Act sets forth factors the institution should consider in making investment decisions. Some factors focus on the nature of the charity and the particular fund. These factors include directions from the donor in the gift instrument, the purposes of the charity and of the fund, the needs of the institution to make distributions and to preserve capital, and other resources of the institution. Other factors look to general economic conditions and to investment strategies that analyze the portfolio as a whole, including total-return investing and sensitivity to the risk and return curve of the entire portfolio.

The language used in Revised UMIFA's articulation of the prudence standard is derived from § 8.30 of the Revised Model Nonprofit Corporation Act and from UPIA. The standard is consistent with the business judgment standard under corporate law, but as applied to charitable institutions and not to businesses. The charitable nature of the institution will affect the decision making of a prudent person acting under the UMIFA standard. For that reason, the Drafting Committee believes that the prudence standard is – and should be – the same regardless of whether a charity is organized as a nonprofit corporation or as a trust. The slight differences in language between the articulation of prudence in UPIA and in the Revised Model Nonprofit Corporation Act do not reflect a difference in the way managers of charities should exercise prudence.

Expenditures from Endowment Funds

Historic Dollar Value. One of the reasons behind UMIFA (1972) was a need to permit investment strategies that did not depend on the characterization of an institution's assets as income or principal for accounting purposes. If an institution could spend only "income" from an endowment fund, then investments in assets with appreciation potential could affect the institution's ability to use its endowment. UMIFA (1972) created the concept of "historic dollar value" and then permitted the expenditure of appreciation in excess of historic dollar value if the institution determined that expenditure of the funds was prudent. Historic dollar value was determined based on contributions to the endowment fund. Income, appreciation and depreciation of assets, and changes in purchasing power, did not affect historic dollar value.

Historic dollar value reflects neither the passage of time nor the investment results for the fund. For some organizations, the historic dollar value floor has little meaning. An institution established in 1930 would have an historic dollar value substantially below the value of the initial gift if adjusted to reflect inflation.

For other organizations, the recent drop in the stock market means that endowment funds established at the end of the 1990s may have historic dollar values significantly higher than their current values. A rule that permits distributions only if the asset value of an endowment fund exceeds the value at the time a donor made contributions could prevent the charity from distributing anything for many years.

Charitable advisors have opined that managers of an endowment fund governed by UMIFA (1972) can continue to spend ordinary income, even when the fund's value is below its historic dollar value. Some underwater funds (funds whose current value is below historic dollar value) may choose to return to the pre-UMIFA world, investing for income rather than using total-return strategies. Of course such an approach will slow the growth of the fund, so that regaining historic dollar value will be even more difficult.

New Approach. Revised UMIFA provides more flexibility to the persons at the institution making decisions about expending funds. The intent is not to allow a governing board to convert an endowment fund into a non-endowment fund, but rather to encourage the board to preserve the purchasing power of the current value of an endowment fund. The institution should be able to establish a spending approach that will be responsive to short-term fluctuations in the value of the fund.

The Drafting Committee replaced the historic dollar value approach with a standard of prudence that applies to the decision-making process of the governing board. Acting prudently and in good faith, the decision makers must consider a number of factors in deciding how much to distribute from an endowment fund. These factors include the purposes of the institution, the intent of donors to the endowment fund, the needs of the institution, the availability of other resources, and general economic conditions.

Donor-Imposed Restriction Limiting Expenditures. A charity must honor a donor's intent in the process of making decisions to expend endowment funds. Any documents relied on by the charity and the donor in setting the terms of the gift will guide the charity as it makes decisions concerning the endowment.

Revised UMIFA provides rules of construction to assist institutions in interpreting donors' intent. If a donor directs a charity to spend "only the income" from a fund or to treat a fund as an "endowment," the donor is unlikely to be concerned about designation of investment returns as "income" or "principal" under accounting principles. Instead, the donor likely assumes that the institution will use modern investing strategies like total-return investing to generate enough funds to make ongoing distributions while maintaining the long-term viability of the fund. The rule of construction in Revised UMIFA assumes that instructions by the donor to the charity to use "only income" from a fund mean that the donor intends that the fund both support current expenditures and be preserved indefinitely.

A donor may restrict the ability of the charity to expend funds under the UMIFA standard, but the donor must state the restriction specifically. For example, a donor might choose to require that a charity spend between three and five percent of the assets held in an endowment 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.

If a donor wants to limit expenditures from an endowment gift to accounting income and does not want the institution to be able to expend appreciation under Section 4 of UMIFA, then the donor must say so explicitly in the instrument making the gift. 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" should be sufficient.

Rebuttable Presumption of Imprudence. The Drafting Committee determined that requiring that those managing endowment funds make spending decisions based on a prudence standard would lead to the best overall results, given the wide differences in the size, nature and purposes of charities. The Drafting Committee does not anticipate that removing historic dollar value will lead to unrestrained spending of endowments. The Committee believes that charities will continue to developing sensible spending rules, as they have under UMIFA (1972), and that those spending formulas will continue to evolve as market conditions and charitable needs change.

Some observers have expressed concern about the lack of more specific statutory guidelines or rules for spending. The concern is that without a bright-line spending rule charities may be tempted to spend more than is prudent or may have difficulty determining a prudent spending pattern and may not spend enough. Attorneys general may find regulating charities more difficult without an easy-to-determine standard.

The Drafting Committee considered including in the statute a rebuttable presumption of imprudence if spending exceeds seven percent of the value of an endowment fund computed over a rolling three-year period. A presumption of this sort is currently part of the UMIFA statutes in Massachusetts and New Mexico. The advantage of a presumption of imprudence is that charities would be unlikely to spend above seven percent in any one year, and the presumption would curb the temptation to spend too rapidly. Further, an attorney general could use the presumption to argue that spending above seven percent was imprudent. An institution can rebut the presumption by showing that in a given year expenditures in excess of seven percent were prudent, after considering all the circumstances affecting the institution and the fund.

The arguments against including a presumption of imprudence in the statute are that the presumption could lead to spending more than is prudent. Although the provision should not imply that spending below seven percent is prudent, some charities might interpret the statute in that way. Decision makers might be pressured to spend more than was prudent, and in the current economic climate spending at seven percent or even six percent would be imprudent for many charities.

The presumption also could make spending on major projects more difficult. For example, a charity might spend only one percent for three years as it saved its endowment for a new building and then spend 20 percent in the fourth year for construction costs. Such a spending decision might be prudent for the charity, but its board might be reluctant to authorize spending that a statute presumes to be imprudent.

The Drafting Committee heard persuasive arguments on both sides of the question of whether or not to include the presumption of imprudence in Revised UMIFA. The Committee concluded that the best approach was to draft the Act without the presumption but to include statutory language for the presumption in the Comments. Each enacting state can then make its own determination as to whether or not to include the presumption when the state enacts Revised UMIFA. And whether or not a statute includes the presumption, governing boards mush remember that prudence controls decision making and that each governing board must make decisions on expenditures based on the circumstances of the particular charity.

Rebuttable Presumption of Prudence. The Drafting Committee considered but rejected a suggestion that Revised UMIFA include a rebuttable presumption of prudence if a charity spends between three and five percent (or between two and seven percent) of the asset value of an endowment fund, determined over a three-year period. The Committee rejected this sort of a spending rule because any fixed range will soon be out of date and cannot take into consideration the range of factors listed in the Act. Further, the use of a presumption of prudence could encourage spending at levels higher than would be prudent in some years.

Delegation of Management and Investment Functions

Being able to delegate is a key element in prudent investing. When the drafters developed UMIFA (1972) they included a provision permitting delegation of investment authority. At the time, the trust rules on delegation were restrictive and their application to nonprofit corporations was unclear. Now UPIA permits delegation by trustees and corporate statutes permit delegation by directors of nonprofit corporations. If adequate rules on delegation exist under other law, they need not be included in Revised UMIFA. Due to the importance of the power to delegate, the Drafting Committee decided to leave Section 5 on delegation in the Revised UMIFA, but the section is bracketed to indicate that many states will not need to include it when enacting Revised UMIFA. If a state does not have adequate law on delegation, then the state should including Section 5. If other laws provide the necessary rules for delegation, then the state can delete Section 5.

Release or Modification of Restrictions

With Donor Consent. As under UMIFA (1972), a donor can consent, in writing, to release a restriction on the use or investment of an institutional fund. The power to release a restriction provided under Revised UMIFA does not create a power with tax consequences for the donor. The initial gift will be a completed gift because the power to release the restriction does not include a power to divert the property from the charitable beneficiary.

Deviation and Cy pres. Revised UMIFA contains two provisions on modification that track the trust law rules of deviation and cy pres. Revised UMIFA permits a court to modify an administrative term of a gift if because of circumstances not anticipated by the donor modification will further the purposes of the gift. The language on deviation is derived from UTC § 412.

Revised UMIFA adopts the cy pres approach provided in UTC § 413. The governing board must seek court approval for the change and must give notice to the state attorney general. The court may release or modify the restriction if the restriction is "unlawful, impracticable, impossible to achieve, or wasteful." Any release or modification must be consistent with the purposes for the fund expressed in the gift instrument. As under cy pres, Revised UMIFA does not require the charity to notify donors to a fund subject to cy pres. Good practice will be to notify all donors who can reasonably be located.

Small Value, Old Fund. If a fund has a total value of less than $25,000 and if the fund has existed at least 20 years, the governing board can apply cy pres itself, without court approval, if the other requirements of cy pres are met. The charity must notify the attorney general of the proposed modification, wait at least 60 days, and then must use the fund in a manner consistent with the purposes stated in the gift instrument.

The Drafting Committee determined that for some small funds that have existed for a long time, a restriction may no longer make sense but the cost of a judicial cy pres proceeding will be prohibitive. The fund may have many donors or because of the age of the fund the donor may be deceased or impossible to find. Either way, obtaining donor consent may not be feasible, so judicial cy pres will be the only option. The Committee wanted to allow a charity to modify the restriction without the cost of going to court.

Input for the Drafting Committee

The Drafting Committee continues to solicit input from anyone with an interest in Revised UMIFA. Comments should be sent to Susan Gary, by email if possible, to sgary@law.uoregon.edu, or by regular mail to Professor Susan N. Gary, University of Oregon School of Law, Eugene, OR 97403-1221. An electronic copy of the current draft of UMIFA can be obtained by requesting it from Susan Gary or by looking online. Go to www.nccusl.org, click on NCCUSL Committees, click on Drafting Committees, and select Management of Institutional Funds Act. A current draft can also be found on the webpage of the Uniform Laws Committee of the RPPT Section.