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SYMPOSIUM: STATE-LEVEL LEGAL REFORM OF THE LAW OF NONPROFIT ORGANIZATIONS: **ARTICLE:** CHARITIES, ENDOWMENTS, AND DONOR INTENT: THE UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT

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BIO:

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SUMMARY:

... In 2006, Harvard's endowment reached nearly \$ 29 billion, 62 university endowments exceeded \$ 1 billion, and 756 universities and colleges held endowments valued over \$ 5 million. ... The Article then focuses on the rules for spending from endowment funds and the role of donor intent in restrictions on endowment fund spending. ... If distributions from an endowment fund depend on the fund's trust accounting income, then a charity might make investment decisions based on the need to generate that sort of income. ... UPMIFA requires each charity to make its decisions on spending from an endowment fund based on the specific circumstances of that fund and that charity. ... Assuming that a donor understood the concept of historic dollar value, spending from an endowment fund will affect that donor's intent that historic dollar value never be spent only if the charity spends below historic dollar value. ... UPMIFA represents several years of effort and input by charities, lawyers who represent charities, donors, banks, law professors who study trust law and nonprofit corporation law, state charity officials, accountants, and other interested persons. ... UPMIFA updates the rules on spending from endowment funds, balancing protection of donor intent with flexibility that will enable charities to cope with economic upturns and downturns. ...

TEXT:

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I. Introduction

American charities manage substantial funds in conjunction with carrying out their charitable purposes, holding some funds for current operating needs and others as endowments. In 2006, Harvard's endowment reached nearly \$ 29 billion, 62 university endowments exceeded \$ 1 billion, and 756 universities and colleges held endowments valued over \$ 5 million. n1 Other types of charities hold significant endowment funds, and the amounts involved continue to grow. n2 The legal rules on managing and investing those funds have worked well, but are now somewhat out of date. Revisions to these rules will benefit donors, charities, and charitable beneficiaries.

Laws regulating charities come from a variety of sources. Trust law provides rules for charities operating as charitable trusts. Nonprofit corporation statutes provide operational guidance and fiduciary directions. Federal tax laws add regulations on activities and behavior. Additional state statutes may focus on specific activities, such as solicitation for charitable funds. Since 1972, the Uniform Management of Institutional Funds Act (UMIFA), a widely adopted uniform act with roots in both trust and corporate law, has provided rules and guidance with respect to the management and investment of funds held by charities. n3 This Article does not address the panoply of regulations governing charities. Rather, the Article takes a narrow focus: the investment, management, and modification of charitable funds subject to UMIFA and the revised version of that Act, the Uniform Prudent Management of Institutional Funds Act (UPMIFA). n4

UMIFA and UPMIFA both provide guidance on investment and management decisionmaking and guidance on spending from endowment funds. The two Acts permit the delegation of authority [*1280] to independent financial advisors and include rules for the release of restrictions on the use or investment of funds. UPMIFA provides additional rules with respect to the modification of restrictions on charitable funds. Both Acts apply to charities organized as nonprofit corporations, unincorporated associations, and other forms, but do not apply to a charitable trust managed by a corporate or an individual trustee.

The story of UMIFA and the decisions made in revising UMIFA to create UPMIFA provide interesting insights into the development of the law that governs funds held by charities. The history of UMIFA fills in a gap in the story of the development of the "prudent investor." An analysis of changes made in UPMIFA can provide guidance to legislatures considering enactment of UPMIFA and serve to assist charities and their advisors in interpreting UPMIFA after its enactment by the states.

II. Historical Backdrop

a. sources of law

The story of UMIFA begins with a look at the way laws regulating charitable organizations have developed in the United States. Most charities are organized and operated either as charitable trusts or as nonprofit corporations. n5 In England and the colonies, charities organized themselves primarily as trusts. n6 After the American Revolution, charities began to form as corporations, and since then, the use of the corporate form has continued to grow. n7 Charities can still use the trust form, and many do, but increasingly charitable organizations operate as nonprofit corporations.

Some rules governing charities and their governing boards depend on the organizational form of the charity, n8 and a charity will look to either nonprofit corporate law or trust law for guidance. [*1281] Separate rules have developed with respect to some issues, but with respect to other issues, the law has developed by combining elements of trust law and corporate law. The sense that a charity holds its funds "impressed with a charitable trust" n9 for the benefit of the public and for the charity's specific charitable purposes has meant that trust law standards have informed the regulation of charities organized as nonprofit corporations. n10 Overall, nonprofit corporation law has developed in a piecemeal manner.

California provides an example of the historical development of the laws applicable to nonprofit corporations. n11 A California statute permitted charities to incorporate as early as 1850. n12 In 1931, California adopted a General Nonprofit Corporation Law, n13 replacing earlier California legislation, but California's General Corporation Law continued to regulate charities in many respects. n14 California courts applied trust rules to some issues involving nonprofit corporations. n15 Only in 1980 did California finally enact a statute that "treated California nonprofit corporation law as a coherent whole." n16 The California statute became the basis of the Revised Model Nonprofit Corporation Act, completed by the American Bar Association in 1987. n17

Although two sets of laws n18 have developed with respect to the regulation of charities—the law of trusts and the law of nonprofit [*1282] corporations—the standards have increasingly merged. n19 Back in the 1960s, however, a lack of statutory guidance, confusion over the standards, and changes in approaches to the investment process led to concerns about restrictions that might prevent large charities from making appropriate investment decisions. n20 These concerns led to the creation of a new statute that would specifically address the investment and management of funds held by nonprofit corporations—they led to UMIFA.

b. investing charitable funds

Fiduciary duties related to investing developed in trust law. The "prudent man rule," first adopted judicially in *Harvard College v. Amory*, n21 required a trustee to invest trust property as the trustee would invest the trustee's own

property. This rule metamorphosed into a rule requiring the trustee to act as a "prudent trustee." n22 As interpreted by the Restatement (Second) of Trusts (1959), this standard encouraged, if not required, conservative investment strategies. n23 The Restatement advised a trustee to avoid speculative investments and to analyze each investment for risk. n24 In addition, [*1283] some states developed legal lists of acceptable investments. n25 A trustee venturing off the list risked an accusation of imprudence. n26

Charities found themselves constrained in their investment options, regardless of whether they operated as trusts or as corporations, due to a general sense that trust law standards applied to charitable organizations and due to the lack of specific legal guidance for charities operating as nonprofit corporations. Investment standards for endowment funds created particular problems. n27 Charities managing endowment funds assumed that they should limit expenditures to income as defined for trust accounting purposes. n28 Trust law definitions of "income" and "principal" meant that expendable income included interest and dividends but not capital gains. n29 Thus, trust accounting principles began to dictate investment decisions. A charity that needed an income stream from its endowment would invest in bonds to produce adequate income. n30 The lack of an equity component in the investment portfolio eroded principal and left the charity in worse shape overall than if the charity could have taken a more balanced approach to its investments. n31

[*1284] c.endowment funds-the cary and bright study

Many colleges and universities hold substantial endowment funds. These educational institutions faced growing problems in the 1960s as inflation rose, bond values fell, and the value of equities increased. n32 Concern about the investment and accounting issues facing colleges and universities led the Ford Foundation to commission a study of endowment funds by William Cary and Craig Bright. n33 Cary and Bright published their report in 1969 as *The Law and the Lore of Endowment Funds*, n34 and the study's findings and recommendations led to UMIFA.

Cary and Bright focused on the concerns of educational institutions, but their legal research encompassed all charities organized as nonprofit corporations. They began by reviewing cases involving nonprofit corporations, in an attempt to determine whether courts applied corporate or trust law standards. n35 In cases that affected the possession of a fund or asset held by a charity, the courts almost always sought to preserve the asset for the charity. n36 The courts used either trust or corporate principles, whichever were more likely to assist the court in reaching the desired result. n37 Cary and Bright noted that the cases evidenced "no undue concern . . . for the niceties of logic and consistency in choosing between the two." n38

When Cary and Bright reviewed the law applied to administrative decisionmaking by nonprofit corporations, they found that most observers and most legal opinions assumed that corporate law and not trust law principles applied. n39 The case review revealed that courts routinely applied corporate standards, n40 and these findings held true both with respect to cases addressing financial administration and with issues involving administration more generally. n41 The Cary and Bright study quotes from a 1951 opinion of the New York Attorney General that stated that the powers of managers of a charitable corporation "in respect to the administration and investment of the corporation's funds are fundamentally no different than that of the directors of a business corporation in respect to the administration of the property held by the corporation." n42 Thus, Cary and Bright found significant support for the idea that trust principles should not govern the investment of funds held by a nonprofit corporation.

Overall, Cary and Bright reported that "[t]he law relating to charitable corporations in general, and particularly to the administration of endowment funds, remains throughout the nation both 'rudimentary and vague.'" n43 They found that the law governing charities organized as corporations had developed with roots in trust law, corporate law, and contract law. n44 With respect to the investment of funds and the administration of the charity's assets, they concluded that courts "show a marked tendency to apply corporate principles rather than trust principles, in order to accord charitable corporations a maximum degree of flexibility in their operations." n45

The Cary and Bright study also analyzed definitions of income. n46 At that time, trust law treated interest and dividends as income and treated capital gains, whether realized or unrealized, as principal. n47 The trust rules had developed to protect the different interests of income beneficiaries and remainder beneficiaries. n48 Corporate law took a different approach, treating realized capital gains as income. n49 And a classic economist's definition of income included unrealized appreciation as well. n50 Cary and Bright noted that only [*1286] trust law treated realized gains as principal rather than income and that trust scholars were beginning to reconsider these traditional views. n51

For large charitable corporations, changes in investment strategies made investing for "income" under a traditional trust definition of income even more problematic. The Cary and Bright study refers to changes that emphasized long-term growth over current return. n52 The theory of efficient markets, or modern portfolio theory, developed further

in the years following the Cary and Bright study, n53 but even by 1969 the benefits of investing more of a portfolio in stocks with growth potential was evident. n54

Cary and Bright wrote that no legal rules required educational institutions to follow restrictive trust law standards in selecting investment assets and trust accounting principles in determining income. n55 The report suggested that rules appropriate to educational institutions should permit total-return investing and other modern investment strategies. The authors concluded with several suggestions for ways to increase the likelihood that charities would engage in these investment strategies: declaratory judgments could resolve doubts about classifying gains as income, legislative revisions could provide statutory authorization, and donative instruments could be redesigned to build in more flexibility for charities. n56

The Cary and Bright study identified three other legal problems that affected endowment funds due to uncertainty as to whether trust or corporate standards applied to nonprofit corporations. One question involved permissible investments. In some states, statutes on prudent investment referred to standards for "trustees" and [*1287] "other fiduciaries." n57 Other states had enacted statutes giving directors of nonprofit corporations broader discretion, n58 and still other states adopted a "prudent man" approach. n59 Cary and Bright noted that prudence depends on the circumstances in which a decisionmaker applies prudence and that a prudent person protecting capital would need to protect the purchasing power of the capital and not merely its original dollar value. n60

Cary and Bright also discussed the standard that should apply for purposes of director liability. The study reported few cases involving directors of nonprofit corporations and noted that some commentators had argued for a strict trust standard and others for the less rigorous corporate standard. n61 Cary and Bright concluded that requiring proof of "bad faith or gross or wilful neglect" was necessary to hold directors of a business corporation personally liable and that the same was likely true for nonprofit directors. n62

Finally, Cary and Bright noted that trust law restricted the delegation of investment decisionmaking. n63 The study explained that directors of large nonprofit corporations would need to delegate investment responsibilities to committees of the board or to officers, and probably were already doing so. n64 In addition, "some use of outside investment counsel is clearly permissible" n65 as long as the directors maintain ultimate control.

d. creation of umifa

In the conclusion of their report, Cary and Bright urged the development of state laws that would provide better guidance for [*1288] educational organizations. n66 The Uniform Law Commission took the advice and began work on what would become UMIFA. n67 After the Commission approved the Act in 1972, forty-seven states plus the District of Columbia adopted UMIFA over a number of years. n68 Although variations exist, the general principles of UMIFA have been adopted almost universally. The Act'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 was, in a sense, a forerunner of the Uniform Prudent Investor Act (1994) n69 and the Uniform Principal and Income Act (2000), n70 two acts that regulate the investment responsibilities and authority of trustees of trusts.

e. upmifa

UMIFA made important improvements to the laws regulating investment and management of charitable funds, but after thirty years a Study Committee appointed by the Uniform Law Commission n71 determined that the time had come for a revision. n72 The Drafting Committee to Revise UMIFA began its work in 2002. n73 During the course of its deliberations, the Drafting Committee received valuable input from lawyers who practice in the field of [*1289] charitable organizations, law professors whose scholarly work addresses the issues involved, state charity regulators and the National Association of State Charity Officials, the reporter for the American Law Institute project "Principles of the Law of Nonprofit Organizations," and representatives from the American Bankers Association, the American Bar Association, and the American Institute of CPA's Not-for Profit Organizations Expert Panel. The Uniform Law Commission approved the Act for promulgation at its annual meeting in July 2006. n74

The next Sections of this Article discuss in detail the issues covered by UMIFA and the changes UPMIFA makes. The Article first discusses the coverage of UMIFA and UPMIFA, explaining what charities and what funds come within its scope. The Article examines the standard for the management and investment of charitable funds, explaining historical issues, changes made by UMIFA, and the new approach of UPMIFA. The Article then focuses on the rules for spending from endowment funds and the role of donor intent in restrictions on endowment fund spending. In connection with endowments, the Article flags problems posed by the accounting standards applicable to charities, including the

Financial Accounting Standards Board's treatment of legally restricted funds as unrestricted for accounting purposes. The Article then considers the rules relating to the release or modification of donor-imposed restrictions on charitable funds.

III. Scope of UPMIFA

a. which funds does upmifa cover?

UMIFA and UPMIFA both apply to those organizations that come within the Acts' definitions of "institution" n75 and to the [*1290] "institutional funds" managed by those institutions for charitable purposes. n76 UMIFA applies to "incorporated or unincorporated organization[s] organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes." n77 UMIFA focuses on organizations operating in the corporate form, because the drafters of UMIFA wanted to provide for those charities rules that differed from the trust rules then in force. n78 UMIFA also applies to unincorporated associations, but few charitable institutions with investment funds operate as unincorporated associations. UMIFA does not exclude all charities operating as trusts, but does not apply to funds for which a corporation or an individual acts as trustee. n79 Thus, all trusts managed by bank trustees are excluded from the rules of UMIFA. UMIFA explicitly includes funds held by a governmental organization for charitable purposes. n80

In working on UPMIFA, the Drafting Committee initially drafted language that would have applied UPMIFA to all funds held by all charities. n81 In the view of many commentators, the rules for the management, investment, and expenditure of charitable funds should not depend on the organizational form of the charity. n82 Some of the provisions UPMIFA adopts derive from trust law, so charitable trusts are already subject to a number of the rules set forth in UPMIFA. n83 In a few respects, however, UPMIFA provides [*1291] new rules and powers for those who manage charitable funds, n84 and the benefits and restrictions of UPMIFA make sense for all charities, regardless of organizational form.

The usefulness of making UPMIFA applicable to funds held by all charities has been demonstrated by issues that have arisen under UMIFA. In a memorandum to the Drafting Committee, a Minnesota lawyer, Hazen Graves, described situations in which a corporate trustee and a charitable beneficiary agreed that a fund would benefit from total-return investing and from not being subject to a distribution policy based on the traditional distinction between income and principal. n85 In several cases, Mr. Graves petitioned the court and received approval for the trustee to treat the trust as if UMIFA governed the trust. n86 Although enactment of the Uniform Principal and Income Act in many states may alleviate the problem, the approach taken by UPMIFA differs from that of the Uniform Principal and Income Act. Thus it seemed sensible to apply UPMIFA to any fund for which the only beneficiary is a charity, regardless of whether a corporation rather than a charity acts as trustee. n87

Although strong arguments exist for applying UPMIFA to all charitable funds, arguments in favor of continuing to exclude funds managed by corporate trustees persuaded the Drafting Committee not to change the coverage of the Act. The Association of American Bankers expressed the concern that charities operated as trusts could be subject to management and investment rules under both trust law and UPMIFA. n88 In a state that adopts uniform versions of the Uniform Prudent Investor Act, the Principal and Income Act, and the Uniform Trust Code, no discrepancies would exist between [*1292] those trust statutes and UPMIFA. In a state that either had not adopted one or more of those uniform acts or had modified an act before adoption, the trustee might confront conflicting rules.

The bankers also voiced their worry about applying UPMIFA to trusts in existence prior to its enactment, because UMIFA did not apply to trusts with corporate trustees. n89 The particular concern was the rule of construction that assists managers in interpreting the language used to give money or assets to an endowment fund. n90 This concern would have been a valid worry if UPMIFA had continued to apply the concept of historic dollar value, n91 but given that historic dollar value no longer applies, n92 the retroactive application of UPMIFA would not have an adverse effect on trusts that had not been covered by UMIFA.

In order to address the concerns of the bankers, UPMIFA does not expand the coverage of UMIFA. Funds managed by corporate or individual trustees continue to be excluded from UPMIFA. n93 An enacting state may, however, want to consider whether to modify UPMIFA before enactment to include all trusts within its scope, or whether to modify the state's existing trust statutes to provide the benefits of UPMIFA to charitable funds managed by corporate trustees.

UPMIFA's definition of institution also includes governmental organizations and branches of government that hold funds exclusively for charitable purposes. n94 Some organizations created by a government may fall outside the definition of institution if the government itself does not manage the fund. For example, in Iowa, the state government established the University of Iowa and provided for a State Board of Regents to control the institution. n95 [*1293] The

Drafting Committee did not intend to exclude such entities from UPMIFA, but variations in state arrangements made drafting a definition that could encompass all possible scenarios too difficult. n96 The comment to the UPMIFA section reminds states to consider adding language to the definition if necessary to clarify that UPMIFA applies to particular situations. n97

b. program-related assets

Like UMIFA, UPMIFA applies to all funds a charity holds for charitable purposes. n98 UPMIFA adds language clarifying that its provisions on prudent investing do not apply to assets held to carry out a charitable purpose; the Act specifically excludes "program-related assets." n99 For example, a university will own buildings to use for offices, classrooms, laboratories, and dormitories. The buildings are assets that have monetary value, but the reasons behind acquiring and maintaining the buildings relate to the purposes of the organization and not to their potential as investments. n100 Other laws applicable to the institution will continue to govern the management of those assets.

The difficulty, of course, is that some assets have both a charitable purpose and an investment purpose. Trinity College, in Hartford, Connecticut, provides a good example. In the 1990s, the area around Trinity College had become depressed and unsafe. n101 [*1294]

The college bought properties adjacent to the university and began to provide low-interest loans to businesses willing to develop the properties. n102 The university did not intend to use the properties directly for university purposes, but it anticipated that revitalizing the area near the campus would result in benefits for the university community and would likely increase student applications. n103 Viewed entirely from an investment perspective, the acquisitions would likely not have been prudent. n104 In contrast, as assets that provided both a degree of investment potential and benefits for the purposes of the university, the purchases made sense. n105

UPMIFA does not preclude a charity from acquiring and holding assets that have both investment purposes and purposes related to the organization's charitable goals. Indeed, UPMIFA directs the decisionmaker to consider the purposes of the institution and of the fund in making investment decisions. n106 Thus, a prudent decisionmaker will consider these charitable purposes in making an investment that may have a program-related purpose but not be primarily program-related. n107 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. UPMIFA does not intend, however, that a charity use a tangential charitable purpose as an excuse for failure to engage in prudent decisionmaking with respect to an investment. A charity should not justify an imprudent investment by later asserting that the investment is somehow related to the charity's purposes.

[*1295]

C. Split-interest charitable trusts

UPMIFA does not apply to split-interest trusts or to any fund with a noncharitable beneficiary. n108 Thus, a charitable remainder trust created to benefit the donor during her life with a remainder to a charity will not be subject to UPMIFA during the donor's life, even if the charity acts as trustee. Following the end of the donor's interest, if the trust continues for the sole benefit of the charity, and if the charity serves as trustee, UPMIFA will apply. n109

IV. Standard for the Management and Investment of Charitable Funds

a. approach taken by UMIFA

Prior to UMIFA, no clear legal guidance with respect to the standard of conduct applicable to managers of charitable funds existed. n110 A general assumption that trust rules applied had problematic consequences for large institutional funds. The Cary and Bright study discussed the conservative approach of some endowment fund managers, an approach that mirrored the approach of trustees under traditional trust law n111 and hampered the ability of charitable organizations to invest for future needs. n112 Further, as the Cary and Bright study made clear, investment decision-making [*1296] and endowment spending rules are inextricably linked. n113 If distributions from an endowment fund depend on the fund's trust accounting income, then a charity might make investment decisions based on the need to generate that sort of income. n114

With guidance from the Cary and Bright study, the Drafting Committee of UMIFA adopted a standard for managing and investing funds that followed what may have already been the approach taken by many charities, albeit without clear legal guidance. More importantly, UMIFA provided statutory support for an approach that made sense for chari-

ties. UMIFA adopted a corporate rather than a trust approach to the management of investment assets, but saying that the Act adopted "the business standard" is incorrect. The Act itself states the standard as follows:

[M]embers of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. [The managers] shall 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. n115

"Facts and circumstances" include the fact that the organization is a charity and not a business. The instruction to consider the charitable purposes of the organization strengthens the point that the managers are not operating a business. The comments make clear that the standard is not simply the business standard. Rather, the standard is "generally comparable to that of a director of a business corporation rather than that of a private trustee, but it is cast in terms of the duties and responsibilities of a manager of a nonprofit institution." n116

[*1297]

B. Evolving concept of prudence

In the thirty years after the promulgation of UMIFA, approaches to investment decisionmaking continued to change. n117 The development of modern portfolio theory and the theory of efficient markets led to new understandings about the investment process. These changes led, in turn, to changes in trust law. n118

Trust law had, since the first adoption of the prudent man rule in 1830, n119 required a trustee to act in prudence when investing and managing the assets of a trust. n120 The prudence standard evolved over time, reflecting changes in investing practices by trustees, but trustees continued to avoid "speculation" as imprudent. n121 Due to concerns about avoiding speculation and preserving capital, trustees were likely to invest heavily in bonds. n122 After World War II, increased inflation and studies showing greater long-term return on equities than on bonds resulted in modest changes in trust investing. n123 As modern portfolio theory became more widely understood, the time came for a more significant revision of trust law.

In the late 1980s the American Law Institute (ALI) revised provisions in the Restatement of Trusts that applied to investment decisionmaking by trustees. n124 The Uniform Law Commission built [*1298] on the work of the ALI and in 1994 approved the Uniform Prudent Investor Act (UPIA), a statute that sets forth rules on investing by trustees. n125

UPIA changed the rules affecting the investment of trust assets in three important ways. First, UPIA increased the duty to diversify trust assets, requiring diversification unless the purposes of the trust are better served by not diversifying. n126 Second, UPIA established a standard of care that adopted portfolio strategy and directed the trustee to adopt "an overall investment strategy having risk and return objectives reasonably suited to the trust." n127 UPIA thus moved trust investing away from the old rules on avoiding "speculative" assets. A trustee was instead to consider the entire portfolio in making investments, allocating risk across the portfolio and not analyzing risk on an asset-by-asset basis. Third, UPIA altered the nondelegation rule that permitted a trustee to delegate only "ministerial" functions and that had been interpreted to mean that a trustee could not delegate investment responsibilities. n128 UPIA reversed this approach, encouraging trustees to delegate while providing a safe harbor for a trustee who exercised "reasonable care, skill, and caution" in selecting an agent, setting the terms of the delegation, and monitoring the agent. n129 Due to the importance of the new approach, in the twelve years following the Act's promulgation, forty-four states have adopted UPIA. n130

[*1299]

C. UPMIFA

With the changes that have occurred in trust law, the standard for investing and managing charitable assets under trust law has merged with the standard for charities organized as nonprofit corporations. n131 The concerns that led to the adoption of a "business" standard in UMIFA no longer exist under current trust rules. UPMIFA reflects the merging of the standards as they apply to charitable organizations by adopting language both from the Revised Model Nonprofit Corporation Act (RMNCA) n132 and UPIA. The combined language indicates that the prudence standard adopted in UPMIFA builds on the "business" standard adopted in UMIFA, using more current language to indicate that prudence, which is in essence the "industry" standard for similarly situated investors, continues to evolve. The use of trust lan-

guage in articulating the standard does not mean that private trust standards apply to the regulation of the management of charitable funds.

UPMIFA uses language from the RMNCA to state the overall duty of care for prudent investing. n133 A charitable manager must act [*1300] "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." n134 The Act then uses language from UPIA to provide more specific guidance for those managing and investing charitable funds. n135 UPMIFA directs the persons 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. n136 The Act lists the factors that commonly bear on decisions in fiduciary investing n137 and incorporates the duty to diversify investments absent a conclusion that special circumstances make a decision not to diversify reasonable. n138

The factors and rules derived from UPIA are consistent with good practice under current law applicable to nonprofit corporations, and trust law norms already inform managers of nonprofit corporations. n139 Although a list of factors to consider may at first seem foreign to a manager or lawyer used to working with corporate statutes like the RMNCA, n140 the details provided in UPMIFA should give useful guidance to a manager directed to act "as an ordinarily prudent person."

[*1301]

D. Socially responsible investing and mission-related investing

Socially responsible investing describes investment decisionmaking that includes the consideration of social or ethical issues as well as financial ones. n141 Advocates argue that investments can, and under some circumstances perhaps should, effect positive social change as well as generate financial returns. n142 The idea of socially responsible investing has evolved both in the sophistication of investment tools available to those who wish to engage in socially responsible investing n143 and in the scope of what socially responsible investing means. n144 Socially responsible funds continue to develop investment screens based on general ethical concerns, but increasingly charities focus on mission-related investing and use some portion of their investments as a means to carry out their specific charitable mission. n145

The idea of socially responsible investing, also called social investing, gained notoriety in the 1970s. n146 Pension funds and universities, in particular, faced growing pressure to engage in social investing. n147 Concerns over apartheid in South Africa led to [*1302] calls for universities to divest in companies that engaged in business in South Africa. n148 Pension funds of state employees were pushed to invest in businesses located in the state, n149 and union pension plans began to invest in "socially desirable projects." n150

In a critique of 1970s social investing, Professors Langbein and Posner pointed out that a trustee owes a duty of loyalty to the trust beneficiaries to carry out the purposes of the trust. n151 The broad approach to social investing taken at the time—the idea of investing in socially desirable projects that have a general social utility but have no particular connection to the mission of the trust—meant that trustees who engaged in social investing were not concerned solely with the interests of the beneficiaries. n152 Langbein and Posner concluded that the duty of loyalty forbids social investing "in its current form." n153 The authors explained that the social principles embodied in the idea of social investing were "poorly specified" n154 and the criteria used to identify "socially irresponsible companies" were "dubious." n155 Issues involved in deciding which investments were socially responsible were unrelated to the purpose of the charity. Langbein and Posner noted that social investing could confer a noneconomic value on the trust beneficiary, one that might compensate for any loss of economic value in the investment. n156 Given the type of social investing engaged in at the time, however, [*1303] Langbein and Posner concluded that the noneconomic value did not directly benefit the beneficiaries of the trust. n157

More recently other commentators have challenged the view that fiduciary duties restrict the ability of charities to engage in social investing. n158 Economic returns on socially responsible funds have improved as the amounts involved have increased. n159 In addition, more focused mission-related investing addresses some of the concerns raised by Langbein and Posner. n160 For example, the John D. and Catherine T. MacArthur Foundation established a socially responsible investment strategy in 1991. n161 The Foundation directs a portion of its portfolio to investments in companies that support one of the Foundation's missions and that have potential for substantial economic growth. n162 The Foundation also develops property it owns in ways that carry out its economic development and environmental missions. n163

UPMIFA does not directly address socially responsible investing, n164 but UPMIFA's guidance on prudent investing can be read to support mission-related investing. UPMIFA requires a charity to consider its charitable purposes in making investment decisions. n165 UPMIFA also includes a factor to consider "an asset's [*1304] special relationship or special value, if any, to the charitable purposes" of the charity. n166 The direction UPMIFA provides with respect to prudent decisionmaking is consistent with the critique made by Langbein and Posner. In directing a charity to focus on its own mission among the factors that guide investment decisionmaking, UPMIFA reminds the charity to comply with the duty of loyalty to carry out charitable purpose of the charity. Investments intended to make political statements unrelated to the charity's mission do not seem to fit within the guidance of UPMIFA. Investments that promote the charity's mission, however, seem consistent with UPMIFA. Indeed, some commentators have argued that a charity that fails to consider its mission when making decisions may breach its duty to carry out its mission. n167

V. Endowment Spending

a. what constitutes an endowment fund?

Most of the rules of UMIFA and UPMIFA, including the rules on prudent investing, apply to all funds held by a charity for charitable purposes, n168 but both Acts include one section that focuses on funds held by charities as donor-restricted endowments. n169 Because [*1305] endowment funds constitute a subset of institutional funds, the management, investment, and modification provisions apply to endowment funds. In addition, UMIFA and UPMIFA provide spending rules for endowment funds. n170 The spending rule of UMIFA made possible the development of current endowment investment practices. n171 UPMIFA modifies the spending rule in ways that should improve the management of endowments.

For purposes of UPMIFA, an endowment fund is a fund to which a donor or donors contributed with the understanding that the fund will be restricted as an endowment. n172 The term does not include a fund that a charity owns without restriction but which the governing board of the charity designates as an "endowment fund." n173 A board-designated fund is not a true endowment, and the governing board of the charity can change restrictions the board has imposed on an otherwise unrestricted fund. If a charity solicits funds for a board-created endowment, however, the solicited funds may be treated as endowment funds under UPMIFA.

A determination of whether UPMIFA will consider a fund an endowment fund depends on the two factors indicated in the definition: the fund is restricted as to the time in which it may be expended, and a donor or donors imposed the restriction. Unless a donor specifies a shorter timeframe, most endowments are perpetual. The donor likely wants the endowment to provide a source of ongoing support for the charity over a long period of time. Sometimes a donor will create a fund to be spent during a specified period of time. n174 For example, a donor might direct a charity to use [*1306] donated assets within a ten-year period. UPMIFA will consider that fund, although not intended to be perpetual, an endowment. The time period specified for its use will affect the charity's application of UMIFA's spending rule because the charity will need to make expenditures at a rate that causes the fund to terminate by the specified date. 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.

The intent of the donor or donors to treat a gift as an endowment fund constitutes the key consideration in a charity's management of the fund. Whether a fund is an endowment fund depends on the terms of the "gift instrument" used to create the fund. n175 A gift instrument includes all written documents, including electronic writings, under which a donor transfers property to a charity. n176 The term does not include verbal discussions between a potential donor and a charity. n177 A charity should be careful not to mislead a donor with verbal representations that may create expectations that the charity cannot or will not meet, and a donor cannot expect verbal wishes to be binding on the charity. Verbal discussions may be useful to the charity in carrying out the donor's wishes, but the legal restrictions imposed on an endowment depend upon written documents. This approach protects both the donor and the charity from allegations based on remembered conversations.

Although UPMIFA uses the term "gift" with an instrument, the term includes writings that do not have a donative purpose. n178 For example, the bylaws of a charity or the minutes of the organization's board meeting could be part of a gift instrument if the documents provide terms under which the charity solicits or holds property. An appropriation by a state legislature for the benefit of a charity could also constitute a gift instrument, and the charity would look to the language of the appropriation for restrictions on the fund. n179 Given the range of documents that may be considered part of a gift instrument, determining which documents control can be critical.

[*1307]

Some donors enter into a memorandum agreement with a charity, establishing the conditions under which an endowment gift will be used. Having a written document of this sort allows both the donor and the charity to understand how the charity will use the gift over time and may address how the charity will adapt the use of the gift to changed circumstances. Other donors may give money or assets to a charity with the instruction that the gift "be held as an endowment" or that the charity use "only the income." Those written directions will create an endowment fund. n180 Still other donors may respond to a written solicitation from a charity, asking donors to contribute to the charity's "endowment fund." Depending on the nature of the solicitation and the response by a donor, the solicitation could constitute a gift instrument and bind the charity to hold contributions received as an endowment fund. n181 In any of these cases the written documents will dictate the terms under which the charity manages the funds.

b.

spending rule

Although a donor can provide specific explanations of the donor's intent with respect to a gift, one aspect of many endowment gifts does not have a clear meaning- the definition of income. A donor may instruct a charity to hold a gift "as an endowment" or to "spend only the income" from a donated fund. If "income" had a definitive meaning, following that meaning could be effective. Because it does not, both UMIFA and UPMIFA provide a rule of construction when a donor uses those and similar terms. n182 Under the rule of construction, the use of these words without more specific instructions creates an endowment fund, subject to the spending rule of the Act.

[*1308]

At the time of the Cary and Bright study, "income" had several different meanings, and charities organized as nonprofit corporations lacked clear guidance for endowment spending. n183 Corporate law included capital gains as income, but trust law did not, n184 and states had not yet enacted statutes specific to nonprofit corporations. n185 The Cary and Bright study advocated legislation that would define income to include both realized and unrealized appreciation. n186

In addition to the confusion over the meaning of income, a rule that limited distributions to interest and dividend income may have affected investment decisionmaking. Fund managers could manipulate investments to generate income or principal, depending upon the need to increase or decrease distributions. Although investing for income might mean higher distributions in the short term, that sort of investment strategy would likely mean a drop in the value of the fund over time.

UMIFA adopted the Cary and Bright recommendation and authorized the spending of appreciation in endowment funds. n187 UMIFA did so by creating the term "historic dollar value" to mean the original value of all contributions to a fund. n188 The Act then permitted expenditures to the extent the endowment fund had appreciated in value above the fund's historic dollar value. n189 The Act authorized a charity to spend the amount above historic dollar value that was prudent, after considering the needs of the charity and general economic conditions. n190

The Cary and Bright study suggested defining principal to mean the original dollar value of the fund, adjusted up or down to reflect changes in purchasing power, plus "a percentage of the adjusted total to serve as a buffer against a possible future decline in the [*1309] purchasing power of the fund." n191 UMIFA used historic dollar value as the original value of the fund and then relied on prudence to include changes in purchasing power as part of the fund's "principal."

The word "income" continues to have multiple meanings, some of which have changed since 1972. As described above, UMIFA provided a meaning for income with respect to endowment funds held by nonprofit corporations. n192 Some donors may be familiar with the UMIFA meaning. Other donors may think of the tax law meaning of income, because income taxes are more familiar to most individuals than principles under UMIFA or trust law. n193 Still other donors may think of the trust law definition of income, now entirely different from the trust rules that applied at the time the Uniform Law Commission approved UMIFA.

The developments in investment practices that led to the Uniform Principal and Income Act (UPIA (1997)) also led to a substantial revision of the treatment of principal and income for trust accounting purposes. n194 UPIA (1997) significantly changed the rules of trust accounting that had been promulgated through the 1931 Uniform Principal and Income Act and the 1962 Revised Principal and Income Act. n195 UPIA (1997) defines some receipts as principal or income n196 but for the most part authorizes the trustee to allocate receipts and disbursements to principal or income

n197 and even adjusts between principal and income after considering all factors relevant to the trust and its beneficiaries. n198 Income under trust law no longer has a bright-line meaning.

[*1310]

The approach taken in UPMIFA builds on UPIA (1997). UPMIFA abandons the use of historic dollar value and applies a new standard of conduct for distributions from endowment funds. n199 As under UMIFA, the underlying rule is prudence, but the factors a prudent decisionmaker should consider have a tighter focus on the nature of endowment funds. The factors emphasize the "duration and preservation of the endowment fund" n200 because endowment funds are established to continue either for a specified period or in perpetuity. The long-term nature of endowment funds is a key component both of donor intent and of prudent management. UMIFA had directed managers to consider factors that focused more on the charity as a whole, although the "facts and circumstances" certainly included the fact that the fund was an endowment. UPMIFA emphasizes the long-term nature of the fund and the need to maintain not only the original dollar value of the fund, but the purchasing power of the fund. Thus, UPMIFA incorporates the concept described in the Cary and Bright proposal, but without a bright-line determination of what maintaining the purchasing power means.

In addition to requiring a charity to focus on the preservation of an endowment fund, UPMIFA lists factors that focus on general economic considerations and the purposes of the charity and of the fund. n201 Charities vary in size and purpose, so each charity's prudent decisionmaking will be unique. For this reason UPMIFA does not take a one-size-fits-all unitrust approach to defining income. The range of charities, the different reasons for creating endowments, and the inevitable changes in economic conditions over time make such an approach impractical.

The Drafting Committee concluded that a prudence standard coupled with more detailed guidance than is found in UMIFA would provide the best rule to govern endowment spending. The elimination of historic dollar value should not lead to overspending of endowment funds. Charities have operated more conservatively than UMIFA requires and should continue to do so under UPMIFA. [*1311] UPMIFA's guidance should encourage charities to develop responsible spending rules for their endowments, enabling the charities to maintain the purchasing power of their funds. n202

c. giving effect to donor intent—rule of construction

The expenditure rule for endowment funds applies only to the extent that a donor and an institution have not reached some other agreement about spending from an endowment. The entire section is "subject to the intent of a donor expressed in a gift instrument," n203 and like most of UPMIFA, the spending rule is a default statute, applicable only if the donor and charity did not agree to a different rule. If a gift instrument sets forth specific requirements for spending, then the charity must comply with those requirements.

The difficulty, as already described, n204 is ascertaining a donor's intent when the donor uses terms like "endowment" and "income." If a donor says, "hold this money as an endowment and use four percent from the endowment each year for your charitable purposes," the donor has given the charity clear instructions. If the charity accepts the gift on those terms, then the charity must comply with the directions, whether or not spending that amount each year would be prudent under the UPMIFA standard. If, however, 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 the rule of construction directs the charity to follow the spending rule in UPMIFA. n205

UPMIFA assumes that the donor's use of the term "income" should not be read to mean trust accounting income, corporate income, or taxable income. The rule of construction assumes that a donor who directs a charity to "pay only the income" from a fund, intends to create a fund that will generate sufficient total returns to [*1312] be able to make ongoing distributions from the fund while at the same time preserving the purchasing power of the fund. The donor likely expects the institution to use modern investing strategies like total-return investing to generate enough funds to distribute while maintaining the long-term viability of the fund.

UPMIFA does not require that a specific amount be set aside as "principal" or as historic dollar value. Instead, 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). The rule of construction of UPMIFA is an intent effectuating provision that construes donors' intent. Because historic dollar value reflects only the original amount contributed and is not adjusted over time, UMIFA may not have adequately captured the intent of a donor who wanted the endowment fund to continue to maintain its value in current dollars. In inflationary times, the donor would likely expect the fund to grow in

value. In deflationary times, spending might appropriately continue even if the nominal value of the fund decreased, as long as the real value of the fund remained the same.

The adoption of a rule of construction for gifts to endowments in UMIFA was not without controversy. The Cary and Bright study reported that "[t]here are those who insist that capital gains of endowment funds must be treated as principal, whether or not the law requires such treatment," and they argued that any other treatment would "thwart the intent of the donors of the funds." n206 The authors also reported the argument that failure to treat capital gains as principal "will lead to a decline in gifts to charity, because donors can no longer rely on their wishes being enforced." n207 Cary and Bright noted that the argument depends on the "questionable assumption" that those making the argument have correctly interpreted the intent of the donors. The authors added that even [*1313] if the interpretation of intent is accurate, history provides examples to counter the argument. n208

Despite concerns discussed in the Cary and Bright study, the construction provision of UMIFA has been widely enacted with no discernible impact on charitable giving. Similar concerns about donor intent were raised during the drafting of UPMIFA, but the Drafting Committee concluded that the rule of construction and the spending rule articulated by UPMIFA provided good rules to guide charities in carrying out the intent of their donors. A donor with a particular interest or concern can enter into a gift agreement with the charity and create other rules, and a charity with a particular plan for its endowment can share its written plan with prospective donors and then that plan will govern the terms of spending from that endowment. n209

d. guidance on prudent spending-no safe harbor

UPMIFA requires each charity to make its decisions on spending from an endowment fund based on the specific circumstances of that fund and that charity. The Act does not provide a safe harbor or presumption of prudence for spending based on a percentage of the fund's assets because a definition of prudence based on a percentage could not take into account the range of charities to which the Act applies, the differences in each charity's purposes and each fund's purposes, and the fact that economic conditions will change over time. The Act as promulgated does include two optional provisions for states to consider. n210 Both provisions address the issue of providing adequate guidance to charities in exercising prudence. The Drafting Committee was not persuaded that the two optional provisions were necessary and did not include them in the final version of the Act. The Committee concluded, however, that given the strong arguments made in favor of each of the two provisions, [*1314] the promulgated Act should include uniform language for these provisions. States considering adoption of UPMIFA should determine whether to include either or both provisions. One provision appears in the Act in brackets; the other provision appears in the comments.

e. rebuttable presumption of imprudence

Concern that charities would be tempted to spend endowment assets too rapidly led to inclusion of a rebuttable presumption of imprudence for spending in any one year an amount that exceeds 7% of the fair market value of the fund. n211 The presumption does not mean that spending up to 7% is necessarily prudent, and under current economic circumstances, spending above 4% or 5% will erode the endowment. n212 The presumption does not take into account specific issues affecting individual charities and funds, but a presumption may provide some protection against imprudent spending. n213 A charity can rebut the presumption of imprudence if circumstances in a particular year make expenditures above that amount prudent.

For some endowment funds, fluctuating spending rates may be appropriate. Although the Act does not apply the percentage for the [*1315] presumption on a rolling basis (e.g., 21% over three years), some endowment funds may prudently spend little or nothing in some years and more than 7% 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% of the value of the fund for construction costs. The decision to accumulate in years one through three and then to spend 20% 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 decisionmaking 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 5% per year but would vary, with spending in some years more and in some years

less. Even if this fund is subject to the presumption of imprudence, spending above 7% in a particular year could well be prudent.

Expenditures from an endowment fund may include distributions for charitable purposes, amounts used for management of the fund, and the costs of fundraising for the fund. Amounts used to pay fund expenses will be deducted from the fund before the institution computes 7% of the fund's value. Thus the 7% will be applied to the net value of the fund and expenditure computations will not include administrative expenses. The costs of administration and fundraising, however, are factors that prudent decisionmakers consider. High costs or fees could be considered imprudent, regardless of whether total spending exceeds 7% of the fund's value. n214

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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. n215

The presumption of imprudence does not create an automatic safe harbor. 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.

f.notification requirement for small funds

The second optional provision addresses the concern that the charities most likely to have difficulty applying a prudence standard for spending without the historic-dollar-value floor will be small charities or charities unused to managing endowment funds. Large charities have sophisticated investment strategies, access to good investment advisors, and experience with spending rules that provide adequate spending while increasing the value of the fund. Historic dollar value has probably not provided much guidance to these charities. For smaller charities, however, additional guidance might be helpful. Several charity regulators advised the Drafting Committee that a notification provision could provide an opportunity for a charity regulator to provide that guidance.

The notification provision requires a charity with total endowment funds valued below \$ 2 million to notify the attorney general before appropriating money for expenditure if the appropriation would reduce the value of the funds below the aggregate historic dollar value of all of the charity's endowment funds. The charity would then wait at least sixty days before making the appropriation. During that period, a regulator in the attorney general's office could review the information and, if [*1317] appropriate, contact the charity. The regulator could provide guidance on prudent spending, discuss whether the attorney general would consider the proposed spending prudent, and, if the regulator had concerns about the spending, suggest alternatives to the proposed spending plan. The charity need not obtain approval from the attorney general before proceeding with the appropriation, but if the regulator advises the charity that the attorney general considers the spending plan imprudent, the charity will likely revise its plan.

Arguments in favor of the notification provision include the fact that it targets the charities that may be most likely to spend imprudently under the new standard. The provision does not require approval by the attorney general, because an approval process could unduly delay a charity's need to move ahead with a spending decision. The provision gives the attorney general's office information that will allow a regulator to intervene before spending occurs rather than learning about excessive spending after the money is gone.

Although the notification provision could be useful, the Drafting Committee raised two concerns about the provision. First, a small charity may not know that the requirement exists and may violate the requirement unwittingly. Education efforts will almost certainly not reach all the small charities this provision will affect. Second, most attorneys general's offices have limited staff resources devoted to supervising charities. If charity regulators in a particular state simply would not have time to review notification reports and counsel the charities submitting the reports, then the requirement may not be helpful. The Drafting Committee concluded that each state should decide whether to include the provision.

g.distinguishing between legal and accounting standards

Accounting rules and legal rules are separate, but accounting rules provide information about restrictions on the use of funds, and legal restrictions imposed on funds affect the way charities can manage those funds. Current accounting

rules ignore the legal [*1318] restrictions imposed by a donor and UMIFA on endowments that are not subject to purpose restrictions. n216

Legal restrictions on endowments come in two forms. A donor may impose a restriction on the purpose for which a charity can use a fund. For example, a fund might be restricted to scholarships for students majoring in economics. Another donor may impose a restriction on when the charity can use the fund by designating the fund as an endowment. A charity cannot spend an endowment fund in one year but rather must maintain it over time, with some spending each year and some growth each year to maintain the purchasing power of the fund. n217 Both restrictions are legal restrictions imposed by a donor on the way a charity can use a gift. The accounting standards treat the purpose restriction as a restriction that affects accounting treatment but ignores the time restriction imposed on the other fund.

Under UMIFA, an endowment fund restricted as an endowment but not restricted as to purpose will be reported for accounting purposes as restricted in the amount of the historic dollar value of that account and unrestricted as to all amounts above historic dollar value. n218 From a legal standpoint, the entire fund is restricted until the governing board makes a decision to spend from the endowment. That is, if the board decides to spend 4% of the value of the fund, then that amount becomes unrestricted. The UMIFA prudence standard continues to restrict the amount in excess of historic dollar value, other than the 4% approved for spending. Although a governing board might be able to decide that spending the entire amount above historic dollar value was prudent, the standard is not [*1319] an empty restriction. A board will violate the restriction if it spends imprudently and can be subject to legal penalties for doing so. A board that treated the fund as unrestricted from a legal standpoint would violate its fiduciary duties. n219

Maine and Utah have responded to the problem the accounting standards raise by including statutory language in their UMIFA statutes indicating that a fund is legally restricted until the charity appropriates funds for expenditure. n220 The Massachusetts Attorney General published an advisory opinion addressing the accounting standards. n221 The opinion explains that funds subject to a donor-imposed restriction should be classified in one of the restricted categories (temporarily or permanently restricted) and not as unrestricted. All three states are trying to require more clarity in financial statements prepared in those states.

UPMIFA cannot address the accounting issues directly because the Financial Accounting Standards Board (FASB) sets accounting regulations. UPMIFA highlights the fact that a donor legally restricts spending when the donor contributes to an endowment fund by including the following language: "Unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution." n222 The hope is that this language will assist accountants in understanding the legal restrictions UPMIFA imposes and in preparing accounting statements that reflect the true nature of an endowment fund.

Because UPMIFA eliminates the concept of historic dollar value, no part of an endowment fund will be considered permanently restricted under current accounting rules. Given this significant [*1320] change, FASB should consider revising the accounting standards to create standards that provide a more accurate reflection of the restrictions imposed on endowments. One approach would be to treat an endowment fund as temporarily restricted until the governing board makes a decision to spend some amount from the fund. That amount would then be reported as unrestricted. Even existing standards that treat an endowment fund as temporarily restricted rather than as unrestricted give a more accurate picture of the nature of the fund. Support for that position comes from paragraph 122 of FAS 117, which states the following:

[I]f net gains are available for use by the organization, those gains are not permanently restricted and classifying those gains as permanently restricted would be misleading. [FASB] agreed and concluded that there is no need to delay recognizing available net gains in unrestricted or temporarily restricted net assets until such time as the organization's governing board acts to appropriate them for use. n223

h. standards developed by the charitable sector

Although UMIFA permits a charity to spend all of a fund's income and appreciation above historic dollar value, the prudence standard has worked effectively in practice so that charities have adopted spending policies that do not involve spending all of a fund's increase in value. Charities 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. Charities have followed this approach even though UMIFA does not require a charity to maintain a fund's purchasing power and allows a charity to spend any amount in a fund above historic dollar value, subject to the prudence standard. Eliminating historic dollar value and providing charities with more discretion should not lead to depletion of endowment funds. Instead, UPMIFA [*1321] should encourage each charity to establish a spending approach that

will be responsive to short-term fluctuations in the value of a fund. A charity can then 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, a charity may appropriately make expenditures even if a fund has generated no investment return that year. Standards will likely continue to evolve and inform charities as the charities apply UPMIFA. n224

i. retroactive application

UPMIFA applies retroactively to funds in existence before its enactment. During the drafting process concerns were raised about retroactive application of the rule of construction. Concerns focused primarily on donor intent, and some observers also raised constitutional questions.

A constructional rule furthers intent by resolving ambiguity when a meaning cannot be determined from the words used. A modification to a constructional rule seeks to increase the likelihood of giving effect to the intent of most people affected. In the case of UMIFA and UPMIFA, the constructional rule applies when a donor has used words like endowment or income without providing specific directions. n225 Retroactive application of UPMIFA's constructional rule might alter the intent of a donor who contributed money to an endowment fund with an expectation that UMIFA would control spending from the endowment fund. Although some donors may [*1322] understand the interpretation made by UMIFA, no empirical evidence exists with respect to whether donors know about historic dollar value or what donors have in mind in contributing to an endowment fund. Anecdotal evidence suggests a variety of understandings and intentions. n226 UPMIFA seems as likely as UMIFA, and the hope is that UPMIFA is more likely than UMIFA, to carry out the intent of donors who make gifts to endowments.

The New Hampshire legislature raised the concern about retroactive application of UMIFA's rule of construction when that legislature considered the adoption of UMIFA in 1973. n227 The New Hampshire Supreme Court concluded that adoption of UMIFA did not violate a provision of the state constitution prohibiting retrospective laws. n228 The court also concluded that the statute would not encroach on the functions of the judicial branch. n229

The Colorado Supreme Court has also considered whether retroactive application of a constructional statute, although not UMIFA, violates the Contracts Clause of the Constitution. n230 The court considered the retroactive application of a default statute involving the donative aspect of an insurance contract. n231 The court concluded that retroactive application is appropriate for a rule of construction that does not alter the substance of an existing contract but rather serves as a default rule that implements donor's intent. n232

Retroactive application of UPMIFA does not violate the Contracts Clause and will likely have a limited effect on donor intent. Assuming that a donor understood the concept of historic dollar value, spending from an endowment fund will affect that donor's [*1323] intent that historic dollar value never be spent only if the charity spends below historic dollar value. Charities typically try to build their endowment, and spending below historic dollar value, while it could happen, will not be the case for most endowments. Of course, many donors probably do not have historic dollar value in mind when they make gifts. For those donors, the rule of construction in UPMIFA may be just as likely to carry out their intent that the fund be held as an endowment as would the rule of construction in UMIFA.

An advantage of retroactive application is that retaining the historic dollar value concept for endowment funds in existence before the enactment of UPMIFA would require charities to manage two sets of endowment funds. For example, a charity 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, greater administrative costs for the charity, and less money available for scholarships.

A further advantage of retroactive application is that UMIFA has been construed to permit the spending of ordinary income, even if the value of the fund has fallen below historic dollar value. n233 An institution with a fund below historic dollar value might, if subject to UMIFA, choose to invest in assets that produce trust accounting income rather than appreciation. n234 Choosing investments based on the characterization of the income could reduce the long-term yield of the fund and, by so doing, contravene the intent of the donors who contributed to the fund.

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VI. Delegation

UMIFA clarifies that directors of a nonprofit corporation can use the services of investment advisors to assist with making investment decisions. n235 The ability to delegate is an important component of prudent investing and thus was

a critical part of UMIFA. In the years since the promulgation of UMIFA, nonprofit corporation statutes and UPIA have adopted the sort of authority to delegate that UMIFA had provided. n236 Thus, charities organized as nonprofit corporations or as trusts have the power to delegate under statutes other than UMIFA. UPMIFA includes an optional section on delegation, n237 but many states will already have statutes that provide the needed authority and will not enact the delegation provisions as part of UPMIFA.

VII. Release and Modification of Restrictions

a. trust law

Over time, a restriction placed on a fund by a donor may no longer make sense, and compliance with the restriction may be impossible or impracticable. In trust law, two doctrines address the problems that occur when provisions of a charitable trust no longer work. The doctrine of cy pres permits a court to modify a restriction imposed on the purpose or use of the trust. n238 A court can apply cy pres to modify the restriction in a manner as near as possible to the intent of the settlor, but only if the restriction has become unlawful, impossible, or impracticable, or, under a modern articulation of cy pres, wasteful. n239 The doctrine of equitable deviation enables a court to modify a restriction on the administration of a charitable trust. n240 [*1325] Deviation effectuates the primary intent of a settlor by allowing the court to modify the manner in which the trustee will carry out the trust purpose but not the purpose itself. n241 The distinction between the two doctrines is not clear cut, and sometimes it seems that courts choose the doctrine that will allow the court to reach the desired result. n242

b. umifa

Although the doctrines of cy pres and deviation probably apply to charities organized as nonprofit corporations, n243 the drafters of UMIFA thought the charities needed additional ways to address restrictions that no longer worked. n244 The comments to UMIFA explain that "[o]ne of the difficult problems of fund management involves gifts restricted to uses which cannot be feasibly administered or to investments which are no longer available or productive." n245 The drafters wanted to provide an additional tool to supplement cy pres. n246

UMIFA permits a charity to release a restriction on either the use or investment of a fund if the donor consents to the release in writing. n247 If the donor does not consent, perhaps because the donor is deceased or cannot be found, then the charity can ask a court to release the restriction. n248 The attorney general must receive notice [*1326] and be given the opportunity to be heard in the proceeding. n249 The court may release the restriction only if the court finds the restriction "obsolete, inappropriate, or impracticable." n250 UMIFA then states that the new rule "does not limit the application of the doctrine of cy pres." n251

UMIFA's release provision is curious in several respects. The provision permits release but not modification, leaving the court with an all-or-nothing choice. A Connecticut case demonstrates the problem with that approach. n252 Yale University sought release of restrictions that required a remainder interest in a trust to be used to build a "wing for the Yale Medical School to be known as the Jane Smallman Wing, for the treatment of the sick poor." n253 At the death of the income beneficiary, nearly sixty years after the death of the donor, Dr. Smallman, Yale no longer maintained separate facilities for the "sick poor," and the money remaining in the trust, \$ 312,086, was insufficient to build a wing for the medical school. n254 Yale sought release of the restrictions under UMIFA. n255 The reported decision addressed the question of whether the fund was an institutional fund subject to Connecticut's UMIFA, because if it were then Yale could request the release. n256 The court determined that the fund was subject to UMIFA. n257 A dissenting opinion points to the problem: a release of restriction under UMIFA will permit Yale to use the fund "for the benefit of its School of Medicine in whatever manner it may choose in furtherance of its educational purposes." n258 If, instead, Yale sought the application of cy pres, the [*1327] court could direct "that the fund be used to approximate the general intent of Smallman - that is, to benefit the sick poor." n259

Although UMIFA does not limit the application of cy pres, the interaction of the release provision and cy pres remains unclear. In a situation such as that in *Yale University v. Blumenthal*, a modification under cy pres rather than a release under UMIFA might have been appropriate. n260 The statute does not indicate whether that is an option and whether the charity or the court would decide which rule to apply. The dissent in *Blumenthal* argued that the court should not treat the fund as one subject to UMIFA, because then the charity's only option for modification would have been cy pres. Cy pres requires consideration of donor intent, while a release under UMIFA does not. n261 The majority opinion states, in a footnote, that "the trial court may apply, and indeed has a responsibility to apply, these doctrines [release and cy pres] to an institutional fund as equity dictates." n262 The lack of clarity, however, remains a problem. n263

Also curious is that UMIFA uses terms that differ from the cy pres terms in effect at the time. n264 The comments do not tell us what would make a restriction "inappropriate," and presumably the intent is to give the court discretion. The comments suggest that the drafters wanted courts to apply the release provisions more willingly than the courts had been applying cy pres. "Inappropriate" appears to be an intentionally easier standard, but the lack of [*1328] comments explaining the intended meaning leaves its application uncertain.

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UPMIFA incorporates the doctrines of cy pres and deviation from trust law, taking an approach that favors modification over release to protect donor intent.

1. Release. UPMIFA provides that with a donor's consent, a charity can release or modify a restriction without court approval. n265 If a restriction becomes unworkable for whatever reason, and if the charity and the donor can agree on an appropriate modification, then they can make that modification by agreement. In many circumstances, a donor is no longer living or a fund has so many donors that obtaining consent to a modification is impractical. But in situations in which the donor is available, the ability to plan for a modification as well as a release of a restriction will be beneficial. The ability of the donor to consent to a release or modification cannot be used to change the charitable beneficiary of the fund and is not a retained power for tax purposes. n266

2. Deviation. A charity can seek modification of a restriction imposed on the management or investment of a fund by notifying the attorney general and petitioning the court for a modification. n267 A provision subject to deviation is one that has become "impracticable or wasteful," one that "impairs the management or investment of the fund," or one that "because of circumstances not anticipated by the donor" will further the purposes of the fund. n268 Using deviation, a court makes changes to the way a charity manages a fund, rather than changes to the purpose for which the donor created the fund. A donor commonly has a predominating purpose for a gift and, secondarily, an intent that the charity carry out the purpose in a particular manner. Deviation is intent effectuating because the doctrine permits a modification that will [*1329] enable the charity to carry out the purposes of the fund more effectively. Any modification must be made, to the extent practicable, "in accordance with the donor's probable intention." n269

The language in UPMIFA section 6(b) is adapted from Uniform Trust Code (UTC) section 412, with one substantive change. Under the UTC, a court can modify both administrative and dispositive provisions if modification is due to unanticipated circumstances. Under UPMIFA, modification due to unanticipated circumstances applies to administrative provisions, termed restrictions on management or investment, and not to restrictions on use. n270 A restriction imposed on the use of a fund can only be modified through cy pres.

3. Cy Pres. UPMIFA adopts the cy pres standard of the UTC, which adds "wasteful" to the traditional reasons for the application of cy pres. n271 Under UPMIFA and the UTC, a court can modify a provision that has become "unlawful, impracticable, impossible to achieve, or wasteful." n272 The court can modify the purpose of the fund or a restriction that affects the purpose. Any modification must be made "in a manner consistent with the charitable purposes expressed in the gift instrument." n273 In making its determination about the appropriate modification, a court can consider releasing the restriction or requiring the charity to transfer the fund to another charity. n274

4. Small, Old Fund Termination. The Drafting Committee sought to address the problem posed for a charity when a restriction on a fund is appropriate for the application of cy pres but the cost of a court proceeding exceeds the value of the fund. Section 6(d) of UPMIFA permits a charity to modify a restriction without going to court, but only if the fund involved is more than twenty years old and has a value of less than \$ 25,000. n275 The fund value chosen for the Act attempts to approximate the cost of a court proceeding, [*1330] including legal fees. n276 A state enacting UPMIFA might choose to increase or decrease the number, depending on costs in that state. The requirement that a fund be "old" protects donor's intent by addressing concerns that a charity might accept money and then turn around and modify a restriction soon after creating the fund.

The small, old fund modification provision should be useful to charities that may be managing multiple small funds with restrictions that have become impossible, impracticable, or wasteful. For example, a university might have a scholarship fund created fifty years ago to provide a scholarship for a student majoring in home economics. Multiple donors contributed to the fund, and most of the donors are either deceased or cannot be found. The university no longer offers a major in home economics and would like to add the \$ 10,000 remaining in the fund to another scholarship fund. The university could seek input from donors who can be located, but donor-sanctioned modification will not be an option because not all donors are still alive. If the university must go to court to obtain approval for modification, money that would otherwise be spent on the charitable purposes envisioned by the donors (scholarships) will be spent to pay for the

court proceeding. A provision permitting the charity to apply cy pres without the expense of a court proceeding will preserve money for charitable purposes.

Under section 6(d), a charity must notify the attorney general and then wait sixty days before proceeding with the modification. n277 The attorney general can review the charity's plans for modification and intervene if necessary to protect the intent of the donors. In the example of a scholarship fund, using the fund for other scholarships related as closely as possible to the original purpose of the donors would be appropriate, but using the remaining money to help build a new football stadium would not. The attorney general can monitor any proposed modifications, work with the charity to develop a better plan of modification if necessary, and initiate a court proceeding if the charity remains unwilling to work on an appropriate solution.

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5. Protecting Donor Intent. UPMIFA emphasizes the importance of donor intent in the way charities manage and spend their funds. UPMIFA provides more detailed guidance to charities than did UMIFA and reminds charities that donor intent remains paramount. Both the standard of conduct for managing and investing funds and the rule on spending from an endowment are subject to "the intent of a donor expressed in a gift instrument." n278 In addition, UPMIFA directs the decisionmaker in both situations to consider the purposes of the charity and of the fund. n279 The purposes of a charitable fund typically lie at the heart of donor intent. Further, with respect to the spending rule, a key factor listed first is "the duration and preservation of the fund" n280 because that factor will matter significantly to a donor to an endowment. n281

The Drafting Committee considered two issues related to donor intent-standing and notification-during the drafting process. The UTC grants standing to a donor to a charitable trust, n282 and the Drafting Committee discussed whether to include a donor standing provision in UPMIFA. Any provision addressing donor standing should balance the need to protect donor intent with the need to shield charities from harassment. The Committee concluded that the issue of standing to object to a charity's management or use of funds was an issue better left to other statutes or to the courts. Under UPMIFA, the attorney general continues to serve an important role in protecting donors who give to charity, as well as in protecting the public's interest in assets held in the charitable stream.

The issue of donor notification surfaced in connection with the modification provisions of UPMIFA. Some observers argued that the Act should require donor notification before a charity used any of the modification provisions. The Committee decided not to include donor notification for several reasons. In many cases, multiple donors have made gifts to a particular fund over many [*1332] years. A requirement that the charity notify every donor would be costly and impractical. A standard requiring the charity to use its best efforts might help, but without assurance as to the meaning of best efforts, a charity might be reluctant to proceed. Publication in a newspaper, suggested by some observers, would be unlikely to result in actual notification.

Current trust law does not require notification of donors for the application of deviation or cy pres, so the decision not to include notification in the modification provisions follows the rule in trust law. UPMIFA relies on the self-interest of charities and on the attorney general. A charity will presumably seek to maintain good donor relations, and part of maintaining donor relations will include notifying donors of any necessary modification that affects their gifts, if at all possible. The attorney general protects the public's interest in funds held by charities and protects the intent of donors who contribute to those charities. The attorney general will receive information about any planned modification and can respond as appropriate. If the charity seeks the application of deviation or cy pres, then the court in its role will also protect donor intent. Although the attorney general may not have sufficient staff to monitor every charitable transaction, an unhappy donor can contact the attorney general and raise concerns about modifications or management of funds. UPMIFA preserves the important position of the state attorneys general as the overseers of charities.

VIII. Ready for Enactment

UPMIFA represents several years of effort and input by charities, lawyers who represent charities, donors, banks, law professors who study trust law and nonprofit corporation law, state charity officials, accountants, and other interested persons. The Act contains some compromises, as does most legislation, but the version adopted by NCCUSL represents an improvement in the guidance the Act will provide to charities and those who manage their funds. UPMIFA provides better guidance to charities concerning the management and investment of their funds, clarifying the authority and duties of fund managers. UPMIFA updates the rules on spending from endowment funds, balancing protection of donor intent with [*1333] flexibility that will enable charities to cope with economic upturns and downturns. UPMIFA also strengthens the modification rules, directing charities to use modification in keeping with donor intent

and providing mechanisms to permit more efficient management of charitable funds. UPMIFA should guide charities in managing their investments and controlling their expenditures in ways that will protect donor intent and result in more effective use of charitable funds for charitable purposes.

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Nonprofit Corporations & Organizations Formation Business & Corporate Law Nonprofit Corporations & Organizations Management Duties & Liabilities Estate, Gift & Trust Law Trusts Charitable Trusts

FOOTNOTES:

n1 Ben Gose & Goldie Blumenstyk, *The Lure of Alternative Investments*, *Chron. Philanthropy* (Wash., D.C.), Aug. 4, 2005, at B1.

n2 *Id.*

n3 Unif. Mgmt. of Institutional Funds Act, 7A U.L.A. 484 (1972).

n4 Unif. Prudent Mgmt. of Institutional Funds Act (2006). The final act can be found at <http://www.law.upenn.edu/bll/nlc/umoifa/2006final.act.htm>. This Article may refer to UMIFA and UPMIFA collectively as "the Acts."

n5 Charities can also operate as unincorporated associations or in other forms.

n6 See James J. Fishman & Stephen Schwarz, *Nonprofit Organizations* 33-36 (2d ed. 2000) (discussing history of charities).

n7 *Id.*

n8 Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 *U. Haw. L. Rev.* 593, 609-15 (1999).

n9 See, e.g., *In re L.A. County Pioneer Soc'y*, 257 P.2d 1, 5-6 (Cal. 1953) (en banc) (applying trust rules with respect to changes in purposes of the corporation).

n10 See Gary, *supra* note 8, at 609-10 (discussing imprint of fiduciary obligations and trust law on charitable organizations).

n11 Fishman & Schwarz, *supra* note 6, at 36.

n12 *Id.* (citing 1850 Cal. Stat. §§ 175-184).

n13 *Cal. Civ. Code* § 593-606 (West 1931).

n14 Fishman & Schwarz, *supra* note 6, at 36.