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CHARITABLE ASSET MAINTENANCE:
Flexibility and Responsibility in the Not-for-Profit Arena

by

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Introduction

Not-for-profit organizations in the United States serve an important role in establishing and assisting society's cultural, social service, health, educational and artistic institutions. Although from the outside, these organizations may appear similar to non-charitable, or private, organizations in many ways, certain basic components of their operation and management, and the resulting legal constraints on their activities, sharply differ from for-profit organizations. One primary distinction between private and not-for-profit organizations relates to the mechanisms by which their activities are scrutinized. In the for-profit corporate context, shareholders, as a result of their financial investment, can serve as a check on both the management and the boards of directors of for-profit organizations. Further, in the private trust context, private beneficiaries of either the income or the remainderman interest have a direct interest in monitoring the trustee's activities.[1]

This is not the case for not-for-profit organizations. Unlike for-profit corporations, not-for-profit corporations are not owned by private individuals.[2] Further, charitable trusts have no private beneficiaries. In the absence of an institutional supervisory mechanism, the role of a charitable organization's board of directors or trustees is paramount.[3] A board of directors is responsible for the organization's operations within the parameters of the legal rules to which the organization is subject, and individual members of boards of directors may be personally liable for organizational mismanagement. Given this context, it is crucial that boards of directors understand the legal rules and have adequate access to information about the organization's assets and activities in order to ensure compliance. This is not necessarily an easy feat, particularly in

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[1] As stated by Professor Karst several decades ago, the law "generally relies on those who are most immediately interested in the property or enterprise administered by a fiduciary to call … enforcement machinery into action." Kenneth L. Karst, "The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility," 73 Harv. L. Rev. 433, 436 (January 1960).

[2] It is true that many not-for-profit organizations are membership organizations and members of those organizations are in some ways analogous to shareholders. However, unlike a shareholder, a member of an organization does not have an ownership interest in that organization; her/his own personal wealth does not rise and fall in relation to the success of the organization.

[3] This paper will use the terms "board of directors" and "board of trustees" interchangeably.

the context of large organizations with complex activities and asset holdings. A primary tool boards of directors use in understanding the assets and activities of an organization is the organization's annual accounting statements. However, the primary purpose of financial statements is not to serve as an internal mechanism to teach board directors about the organization. Rather, the financial statements serve primarily to educate donors, members and creditors. The statements are in fact the *responsibility* of the board and are not designed to educate the board.

The interplay between the legal constraints on a not-for-profit organization's activities, the board of directors' role in assuring the organization operates within the parameters of these constraints, and the access of board members to comprehensive and comprehensible information about the organization are particularly evident when it comes to the management of charitable assets held by the organization. The legal rules governing a not-for profit organization's handling and preservation of its charitable assets are imposed by the laws of the individual state in which that organization was formed and may also be imposed by the laws of the state in which those assets are held and the organization operates. These laws range from general standards of care imposed on the governing board of the organization to more specific rules regarding the expenditure of charitable assets.

When assets are contributed to a charity as "endowment funds," meaning that they are contributed subject to donor restrictions as to their expenditure, state law generally imposes specific restrictions on the charity's ability to invest and spend such assets. The primary restrictions that have generated considerable confusion in the not-for-profit community are the proper limits on an organization's ability to invest charitable assets, to delegate responsibility for the investment of its assets, and to spend the return on those investments.

Boards of directors now generally understand their duty to maximize the return on the investment assets held by not-for-profit organizations, both to support current operations and to ensure their organizations' futures to carry on their missions. There is for the most part an acceptance of modern portfolio theory with its emphasis on a diversified portfolio, and allocation of investments assets among different types of investments. The natural corollary of modern portfolio theory is the adoption of a "spend rate" for an organization, a percentage -- generally ranging from three to seven percent-- of the rolling average of the value of the organization's investment assets over a period of time, say the last twelve to twenty quarters, in order to smooth out bumps and blips in value.[4] The resulting amount is drawn down annually to cover current operations of the organization, and the aim is generally that the return on the organization's assets, after the annual draw down, will at least equal inflation, so as to protect the purchase power of the organization.

This practice and acceptance of the total return concept is a development primarily of the last thirty years, sanctioned for not-for-profit corporations with the adoption of the Uniform Management of Institutional Funds Act ("UMIFA"), which has been adopted in one form or another in most states. Despite its acceptance, however, boards of directors face a panoply of issues in their investment and expenditure practices, particularly when dealing with endowment funds and the state laws governing their management and maintenance and often do not have access to sufficient information concerning the organization's endowment funds. Although endowment funds are reflected on an organization's financial statements, they are not necessarily reflected in a manner that is most useful to a board director in its endeavoring to comply with endowment fund maintenance rules.

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This paper discusses the legal rules and the accounting standards applicable to the investment and handling of the endowment fund assets of not-for-profit organizations. The paper endeavors to provide a historical context for these rules and standards and points out areas where the rules hinder the efficient management of not-for-profit organizations, or where the legal rules on the one hand and the accounting rules on the other are not completely harmonized. Moreover, it attempts to point out the need for an

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[4] Most organizations use fair market value in calculating the rolling average, although some use the assets' book value. *See* Joel C. Dobris, "Real Return, Modern Portfolio Theory, and College, University and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules," 28 Real Prop., Prob., & Trust J. 49, 63 (1993).

organization's board of directors, and financial officers, to be properly educated about the legal constraints which they face, and the need to scrutinize and understand the organization's financial statements.

Part I discusses the historical context out of which the legal rules applicable to charitable asset maintenance emerges. Primarily, it looks at the development of the standard of care imposed on fiduciaries and the restraints on their ability to invest and manage assets from its genesis in the private trust law area. While this paper generally focuses on the rules applicable to not-for-profit corporations (rather than charitable trusts), this section on the history of developments in the standard of care has been organized chronologically because the developments in trust law and not-for-profit corporate law have a curious history and have leap-frogged one another. This part also explores the non-statutory constraints on investment of charitable funds.

Part II of this paper turns from legal rules to accounting rules. This section summarizes the standard accounting rules applicable to charitable organizations promulgated by the Financial Accounting Standards Board ("FASB"). Part III discusses the interaction of the legal and accounting rules. It focuses on several aspects of the accounting rules that are at somewhat cross purposes with the legal constraints on charitable organizations and consequently may not serve to provide an accurate snapshot of a charitable organization's available assets. This section also discusses some of the areas in which the accounting rules are subject to interpretation, thus impeding the goal of standard disclosure across all charitable organizations.

Finally, Part IV endeavors to sum up where we are now and raises some issues for consideration, including suggesting a potential mechanism for ensuring board of director awareness of an organizations' endowment funds that does not rely on the organization's financial statements.

Part I. **The Historical Context and Current Developments.**

A. General.

The laws governing the investment activities of not-for-profit organizations derive from the laws governing trusts. The notion that a fiduciary is subject to legal restrictions on its management of assets held in trust is one with deep roots in English common law.[5] This law often imposed very formalistic restrictions on the ability of fiduciaries to invest trust assets. In fact, the English Court of Chancery published a list of acceptable assets in which trustees could invest charitable assets, principally comprised of government securities.[6] In the background of this inflexible regime was a general understanding that investments in other than fixed income securities such as government bonds was "speculation," and to be avoided.

In the United States, however, there was a much more limited pool of governmental securities available and those assets were not necessarily safe investments. Some trustees invested trust assets in assets other than debt securities, including equity investments. In reviewing whether a trustee had breached its fiduciary duty with respect to a trust that suffered a significant loss in value due to the decline in value in its equity investments, the Massachusetts Supreme Judicial Court noted in 1830 the fallacy in thinking that some investments were inherently safe and others inherently unsafe.[7] Uttering its famous statement regarding the inherent risk involved in investment, "[d]o what you will, the capital is at hazard," the Court announced a new standard of care applicable to investment of trust assets, the "prudent man" standard. As the court articulated this standard:

> All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering

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[5] Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule*, p. 11 (Oxford 1986).
[6] *Id.*
[7] *Harvard College and Mass. Gen. Hosp. v. Francis Amory,* 26 Mass. (9 Pick) 446, 469 (1830).

> the probable income, as well as the probable safety of the capital to be invested.[8]

As described by Bevis Longstreth, this standard did not gain wide acceptance outside of Massachusetts until the 1940s.[9] Many states in fact promulgated lists of acceptable investments, primarily fixed-income securities, similar to the lists of the English Court of Chancery.[10] The New York Court of Appeals, in fact, announced in an 1869 decision, *King v. Talbot,* that common stock investments were inherently imprudent.[11]

As Longstreth describes it, in part in the wake of the collapse of the bond market in the 1940s, states began to move toward adopting a more flexible approach to the investment management of trust assets, codifying prudent man standards. Further, in 1942 the American Bankers Association promulgated the Model Prudent Man Investment Act, which adopted as its standard of care the standard adopted by the Massachusetts Supreme Court in 1830 in *Harvard v. Amory*.[12]

Despite the flexibility of the language of the prudent man standard, fiduciaries with respect to trust assets nonetheless were constrained in their investment activities as a result of interpretations of the standard by commentators. As Longstreth argues, it is primarily the interpretation of the standard in two authoritative texts in the private trust arena, the 1959 Restatement (Second) of Trusts and A.W. Scott's influential treatise, *Law of Trusts,*[13] which dramatically reduced the flexibility in the rule. These texts changed the standard from that of the prudent man, which charged the trustee with the duty to treat trust property as s/he would treat her/his own property to the "prudent trustee," who uses "the caution in making investments which is used by prudent men who have primarily in view the preservation of their property, of men who are safeguarding property for others."[14] Further, these treatises tended to prioritize conservative investments, even if the return on

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[8] *Id*.
[9] Longstreth, *Modern Investment Management and the Prudent Man Rule* at p. 12.
[10] *See, e.g.*, N.Y. Pers. Prop. Law §21(1).
[11] 40 NY 76 at 87-90 (1869).
[12] Longstreth, *Modern Investment Management and the Prudent Man Rule* at p. 13. In 1969, the Uniform Probate Code § 7-302, in 1972, UMIFA, and in 1974 the Employee Retirement Income Security Act, also adopted versions of the prudent man standard.
[13] A.W. Scott, *Law of Trusts* (3d ed. 1967).
[14] Scott, *Law of Trusts,*§ 227.3.

those investments resulted in diminishing the original purchasing power of the trust. Finally, both texts spoke against speculation and set up categories of permissible and generally impermissible investments.[15] As applied by courts in various states, a strong emphasis was placed on avoiding speculation.[16]

By focusing so singularly on specific investments that were speculative, these treatises discouraged consideration of overall investment performance. Specific investments can always depreciate. Today, holding an investment manager accountable for the decrease in value of a single investment within a large investment portfolio would be unusual, particularly if the portfolio as a whole enjoys appreciation. Nonetheless, the singular focus in the commentary on the investment results of each particular investment discouraged trustees from purchasing other than very conservative securities.[17]

Under the influence of the *Restatement* and the *Law of Trusts*, trustees were extremely constrained in their management of trust assets and were unable to invest assets in accordance with modern investment practices. As early as 1934, in an influential treatise in the field of economics, Professors Graham and Dodd noted the fallacy of the typical bifurcation of investments into those that are and are not speculative.[18] In fact, the typical modern investment portfolio combines a range of assets in terms of their level of investment risk.[19]

Finally, as the number of available investment options increases, and as expertise in specific areas of investments becomes more specialized, modern investment practice typically involves a certain amount of delegation of investment activities to those with

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[15] The 1959 Restatement (Second), for example, states that the purchase of shares of stock on margin or bonds selling at a discount due to uncertainty as to whether they would pay on maturity is speculative and imprudent. Restatement (Second) of Trusts § 227 cmt. f. Additionally, junior mortgages were considered in some jurisdictions to be imprudent, as were investments in "new and untried enterprises."

[16] John H. Langbein, "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 Iowa L. Rev. 641, 644 (March 1996).

[17] *See* Evelyn Brody, "The Limits on Charity Fiduciary Law," 57 Md. L. Rev. 1400 (1988).

[18] *See* Benjamin Graham & David L. Dodd, *Security Analysis* (McGraw Hill 1934), *as cited in* Longstreth, *Modern Investment Management and the Prudent Man Rule* at p. 87. Longstreth points out that despite the influence of this treatise within the economics community, there was typically little dialogue between the legal and the economics communities and so the drafters of the Restatement one year later may not have been aware of the issues raised in Graham & Dodd's treatise. *Id.*

[19] Modern investment practices frequently incorporate equity along with other more recent forms of investment assets, such as derivatives and hedging transactions. Additionally, it is not at all uncommon in modern investment practice to purchase securities on margin.

necessary expertise. However, private trust law generally prohibited trustees from delegating any of their activities in managing trust assets. If the trustee could reasonably be required to personally perform a specific act, that act could not be delegated.[20] Professor Langbein suggests that the rationale for this rule is "murky" and may stem from the settlor of the trust's personal reliance on the personality of the trustee.[21]

It was clear to many that the prudent man standard was a failure in application. Commentators urged that the standard of care applicable to trustees requires a focus on the careful and deliberate process of the trustee in managing trust assets, rather than on the success or failure of specific investment assets chosen by that trustee.[22] As Longstreth stated in 1986, although hailed as "a bright star in a newly discovered galaxy," the prudent man standard as it has been interpreted, "ha[s] made a black hole the more likely metaphor."[23]

B. The Total Return Concept – Developments in Corporate Law in the 1960s and 1970s.

Given this background of trust law, most endowments of not-for-profit organizations were primarily invested in fixed income securities, such as bonds, which provided a dependable income stream, but which provided meager overall returns.[24] The need for current income often outweighed the long-term interest in growth. This practice, however, not only precluded maximum growth, but also "allow[ed] the value of the underlying endowment assets to be eroded by inflation over time."[25]

This pattern of conservative investing persisted into the mid 1960s.[26] However, at that point, due to changing market conditions, managers of endowment funds at

[20] *See* Restatement (Second) of Trusts § 171.
[21] Langbein, "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 Iowa L. Rev. at 650; *see also* Langbein, "Reversing the Nondelegation Rule of Trust Investment Law," 59 Mo. L. Rev. 105, 106-110 (1994).
[22] Longstreth, *Modern Investment Management and the Prudent Man Rule* at 152-153.
[23] *Id.* at p. 13.
[24] Mary Shmid Daugherty, *Uniform Management of Institutional Funds Act – the Implications for Private College Board of Regents*, 57 WEST'S ED. LAW REP. 319, n.3 (1990).
[25] Terry L. Simmons, *The Uniform Management of Institutional Funds Act and Its Meaning for Colleges and Universities*, AGB PUBLIC POLICY PAPER SERIES at 2.
[26] Douglas M. Salaway, Note, *UMIFA and a Model for Endowment Investing*, 22. J.C. & U.L. 1045, 1054 (1996).

educational institutions began to question the wisdom of the currently prevailing investment practices. While earlier in the decade, inflation was low and college enrollment "historically high,"[27] in the late 1960s enrollment slowed, inflation rose, and, as interests rates went up, outstanding bond values declined.[28] Throughout the sixties, however, the overall value of investments in equity securities had increased sharply.[29] While most funds were suffering, as a result of their substantial holdings in bonds, those institutions that had a greater portion of their investments in stocks benefited considerably.[30]

The temptation—even the need—to alter investment strategies to increase investment holdings in stock faced several obstacles. The root of this difficulty was the fact that it was believed that endowment spending should be managed consistent with traditional private trust law, spending only income and leaving the principal untouched.[31] As income was defined under private trust law principles, it included items such as interest and dividends, but did not include appreciation, realized or unrealized, on investment assets.[32] Capital gains were generally considered part of principal and were required to be retained for the trust remainderman.[33] A shift toward greater overall holdings in equity would have the benefit of increasing overall appreciation on fund assets, but that appreciation could not be spent under traditional trust law principles—only the dividend income on those securities could be spent. And since at that time dividend rates were lower than the rate of return on bonds, the shift to greater overall holdings in stocks would put organizations in a worse position than they were already in, in meeting operating expenses.[34]

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[27] Daugherty, *supra* note 24 at 319.
[28] *Id.* at n.3. It was during this period that governing boards needed to rely more on their endowment funds. *Id.* at 319.
[29] *See* William L. Cary & Craig B. Bright, *The Law and the Lore of Endowment Funds,* Report to the Ford Foundation at p. 5 (1969) ("*The Law and the Lore*") (during the 1960s, the average price of common stocks rose seven times as fast as the cost of living).
[30] Simmons, *supra* note 25 at 4.
[31] Salaway, *supra* note 26, at 1054
[32] Cary & Bright, *The Law and the Lore* at p. 13.
[33] *Id.*
[34] Salaway, *supra* note 26, at 1055.

Witnessing the greater overall return they could potentially enjoy through holding stocks, yet recognizing the need for current income, many colleges shifted their focus to a total return investment strategy, questioning the applicability of private trust law principles to charitable asset maintenance.[35] The total return strategy, in which "both yield and capital appreciation are treated as income, less an amount that must be reinvested to compensate for inflation," would provide the flexibility needed to maximize the value of endowments.[36] External pressure also fueled interest in a total return investment strategy as a result of widespread press coverage of the dwindling value of funds at several major institutions.[37] As one author explained, "[t]he negative press was disconcerting for both the development office responsible for the fund raising and the governing board responsible for managing funds. It was obvious that these funds needed more active management and/or new investment policy."[38]

Some educational institutions maintained a policy that appreciation could be expended. Harvard University, for example, took this approach with respect to its considerable endowment appreciation, drawing the attention of other institutions.[39] However, there was doubt about the legality of this approach, and organizations concerned with liability continued, and were advised, to maintain their policy of expending only income, and thus were forced to invest conservatively in current income-producing assets.[40]

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[35] William L. Cary & Craig G. Bright, *The Developing Law of Endowment Funds: "The Law and the Lore" Revisited,* A Report to the Ford Foundation at pp. 9-10 (1974) ("*The Law and the Lore (Revisited)*"); Salaway, *supra* note 26, at 1055.
[36] UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT, Prefatory Note, 7A U.L.A. 475, 476 (1999). Several different kinds of spend rates have been adopted by charitable organizations. Organizations vary in the percentage of the value of their assets that may be drawn-down for expenditure and in the number of months over which the organization determines the average value of the assets. Further, some organizations adopt a policy that allows for fluctuations in the percentage draw-down, but subject to a cap. Additionally, some organizations have adopted complex formulas where the percentage of assets that may be spent in any year shifts in relation to asset performance within a time period. *See* Joel Dobris, "Real Return, Modern Portfolio Theory, and College, University and Foundation Decision on Annual Spending from Endowments: A Visit to the World of Spending Rules," *supra* note 4 at 65.
[37] Daugherty, *supra* note 24, at 320.
[38] *Id*.
[39] Simmons, *supra* note 25 at 2.
[40] *Id*. See also Unif. Mgmt. of Institutional Funds Act, Prefatory Note, 7A U.L.A. at 476. Kenneth Karst points out that unlike the beneficiaries of a trust or shareholders in a corporation, charities have "no beneficiary in a comparable position who is sufficiently interested as an individual to call the charitable

There was a surprising lack of legal authority in this area to guide fund managers and trustees.[41] Nonprofit and general corporate statutes did not address the investment of and ability to expend endowment funds. Further, there was uncertainty as to whether different rules should apply to charitable assets held in trust on the one hand and held in corporate form on the other. In practice, charitable trusts were often more frequently the subject of litigation, courts tending to be more likely to apply trust law principles to charitable entities organized in trust form.[42] Calling for a law specific to charities, in 1960 Professor Kenneth Karst pointed out the illogic in treating charitable trusts and corporations differently merely based on their form.[43] Karst stated that there was "no good reason for making different rules for the managers of two large foundations simply because one is a corporation and the other a trust. The law should recognize that the charitable trust and the charitable corporation have more in common with each other than either has with its private counterpart."[44] Despite Karst's plea, it would be more than a decade before any development of a law applicable to charities, and another thirty years before the development of the law explicitly applicable to charitable trusts.[45]

1. <u>The Law and the Lore of Endowment</u>

Fueled by the inefficiency of the then-prevailing approach to investment and accounting by colleges and universities, in the late 1960s, the Ford Foundation commissioned William Cary and Craig Bright to examine whether total return investing could be adopted by educational institutions.[46] Their seminal study concluded that it could, and that colleges and universities were “giving up capital gain returns because of mistaken definitions of prudence and a desire not to lock up capital gain in perpetuity in

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fiduciary to account." Karst, "The Efficiency of the Charitable Dollar," *supra* note 1 at 436. Though Karst was discussing the enforcement of laws governing charitable fiduciaries, this lack of enforcement also suggests a lack of pressure to maximize return, perhaps explaining why conservative, inefficient investment trends persisted for so long.

[41] As the Prefatory Note to UMIFA states, "[t]here is virtually no statutory law regarding trustees or governing boards of eleemosynary institutions, and case law is sparse." 7A U.L.A. at 477.

[42] *See* Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule* at p. 23.

[43] Kenneth Karst, "The Efficiency of the Charitable Dollar," *supra* note 1 at 436.

[44] *Id.*

[45] However, as discussed below, equal treatment of charitable trusts and charitable corporations has not yet been achieved.

[46] Cary and Bright, *The Law and the Lore*.

endowments."[47] As suggested by the title of their report, Cary and Bright found that "legal impediments which have been thought to deprive managers of their freedom of action appear on analysis to be more legendary than real."[48]

Cary and Bright questioned the applicability of state private trust law to educational organizations. First, they noted that there was no specific law requiring the application of private trust law in the charitable context, stating, "[w]e find no authoritative support in the law for the widely held view that the realized gains of endowment funds can never be spent."[49]

But in addition to the fact that there was no law requiring the application of private law principles, Cary and Bright argued that such principles were not logically consistent in the charitable context.[50] First, unlike in the private trust law context, there is no adversity between the income beneficiary and the remainderman in the charitable endowment fund context. While the fiduciary of a charitable endowment is responsible for maintaining the fund in perpetuity, it is not required to strike a balance between two adverse parties.

Cary and Bright also pointed out that the definition of "income" in contexts other than private trust law did not exclude appreciation. For example, statutes defining corporate income or its accumulation "invariably encompass realized appreciation within the scope of their definition."[51] Further, the Haig-Simons concept of income, which was the then-prevailing economic concept of income, would include all measurable appreciation in income.[52] Although by operation of the income tax law -- a realization-based system of taxation -- there is generally a sharp distinction between realizing

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[47] Joel C. Dobris, "Real Return, Modern Portfolio Theory, and College, University, and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules," *supra* note 4 at 52.
[48] Cary and Bright, *The Law and the Lore* at p. 66.
[49] *Id.*
[50] Note that even prior to Cary and Bright, there was an acknowledgment that the then-prevalent lists of permissible investments for private law trustees should not apply to trustees of charitable corporations. *See* Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule* at p. 24 (*citing,* Restatement (Second) of Trusts § 389 comment b).
[51] Cary and Bright, *The Law and the Lore* at p. 27.
[52] *Id.* at p. 28-29.

appreciation and leaving it unrealized, Cary and Bright pointed out that such distinction is not as significant for tax-exempt organizations.[53]

Cary and Bright urged states to develop laws applicable to educational organizations that would permit modern investment strategies and practices. They concluded their study:

> Anglo-American law has never stood for long in the path of progress, but has accommodated to changing needs. This is and should be its role and function in the field of education.[54]

2. UMIFA – Embracing the Total Return Concept

In the early 1970s, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") set out to promulgate a uniform code in order to permit institutions holding endowment funds to invest in long-term growth investment assets, yet, at the same time, have funds available for expenditure on a current basis. In 1972, they promulgated UMIFA to address these concerns as well as others in the area of endowment fund maintenance. Although the focus of Cary and Bright's study, *The Law and the Lore,* was the particular problem facing educational institutions holding endowments, drafters of UMIFA realized that "the problems were not unique to educational institutions but were faced by any charitable, religious or any other eleemosynary institution which owned a fund to be invested."[55] As a result, UMIFA applies to funds held by an "incorporated or unincorporated organization organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes, or a governmental organization to the extent it holds funds exclusively for any of these purposes," provided that such funds are held by the institution for its "exclusive use, benefit or purposes."[56] Given this broad definition, UMIFA applies generally to colleges, universities, hospitals, religious organizations and other institutions of an eleemosynary nature.[57]

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[53] *Id.* at pp. 34-35.
[54] *Id.* at p. 66.
[55] UMIFA, Prefatory Note, 7A U.L.A. at 477.
[56] UMIFA §1(1), 1(2).
[57] See Comment to Section 1 of UMIFA, 7A U.L.A.

By its own terms, UMIFA does not apply to funds held for a charitable institution by a trustee that is not a charitable institution (e.g., a community foundation in which a bank or other financial institution acts as a trustee) or a fund in which a non-charitable beneficiary has an interest (such as a split interest charitable lead or remainder trust).[58] UMIFA does not preclude its applicability to charitable trusts generally, but it does not clearly state that it does apply to charitable trusts. Further, many states that have adopted UMIFA have limited its applicability to state not-for-profit corporations.[59]

3. Expenditure of Endowment Fund Assets

The operative provision of UMIFA that enables an organization to adopt total return spending policy is Section 2, "Appropriation of Appreciation." It states that:

> The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent ....[60]

Under this provision, an organization is authorized to spend amounts relating to the appreciation on endowment fund assets. The appreciation may be spent even if such amounts are not realized, including when all or part of the endowment fund is invested in long-term growth securities. The organization, in other words, need not feel constrained to spend only the income (such as interest, dividends, rents or royalties) generated from the investment assets.[61]

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[58] See Comment to Section 1 of UMIFA. For example, where the trustee is a bank or trust company holding funds for the sole benefit of an organization, UMIFA does not apply. *Id.* UMIFA also does not apply to "a fund in which a beneficiary that is not an institution has an interest, other than possible rights that could arise upon violation or failure of the purposes of the fund." *Id.*

[59] *See, e.g.,* New York N-PCL. However, Connecticut, Hawaii, Indiana, North Carolina, Virginia and West Virginia have adopted UMIFA-based statutes applicable to community foundations organized in trust form. Jane L. Wilton, "Endowment Funds of Not-for-Profit Corporations," *Professional Tax and Estate Planning Notes,* (October 2003). The rules generally governing the maintenance of endowment funds held by charitable trusts are found in state trust laws, including the versions of the Uniform Principal and Income Act adopted in various states.

[60] UMIFA §2.

[61] UMIFA does not restrict the expenditure of a fund's income under any circumstances. Thus, even if a fund has dropped below its historic dollar value due to depreciation of the assets in which the fund is invested, the income generated by those assets are not restricted from expenditure under UMIFA.

An "endowment fund" is defined under UMIFA as "an institutional fund, or any part thereof, not wholly expendable by the institution on a current basis under the terms of the applicable gift instrument."[62] Thus, Section 2 only applies to "donor-restricted" funds and does not apply to funds wholly expendable by the institution, but which the institution elects to restrict as to their expenditure.[63] Nor does Section 2 apply to funds held by an institution that are restricted merely as to their use. For example, a donation to a charitable institution organized for the protection of the environment where the applicable gift instrument requires that the funds be used solely for preservation within a designated geographic region is not an endowment fund within the meaning of UMIFA merely because of the use-related restriction. By contrast, if the gift required that the original gift amount be preserved and retained by the organization, the gift would create an endowment fund within the meaning of UMIFA.[64]

Important to the operation of Section 2 of UMIFA is the concept of "historic dollar value." This is defined in UMIFA as:

> the aggregate fair value in dollars of (i) an endowment fund at the time it became an endowment fund, (ii) each subsequent donation to the fund at the time it is made, and (iii) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the fund. The determination of historic dollar value made in good faith by the institution is conclusive.[65]

Under this definition, the historic dollar value of a gift is generally the fair market value of the gift at the time it is made. For example, the historic dollar value of a $1,000 donation to an organization in order to create an endowment fund will be $1,000. If the donor makes a subsequent donation to that fund in the amount of, say, $1,000, the historic

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[62] UMIFA §1(3).
[63] Such funds are often called "quasi-endowment funds" or "funds functioning as endowment." There is a substantial amount of confusion in many organizations about the funds to which UMIFA applies. The concept of "quasi endowment" may not be understood and because many organizations hold their endowment funds, quasi-endowment funds and unrestricted operating funds in a general investment pool, their officers and boards may not understand which of these funds are subject to UMIFA.
[64] The term "gift instrument" under UMIFA means "a will, deed, grant, conveyance, agreement, memorandum, writing, or other governing document (including the terms of any institutional solicitation from which an institutional fund resulted) under which property is transferred to or held by an institution as an institutional fund." UMIFA §1(6).
[65] UMIFA §1(5).

dollar value of the fund will be $2,000 ($1,000 plus $1,000). Further, if a gift instrument directs accumulation, historic dollar value will increase with respect to such accumulation. In other words, if, for example, a donor makes a $1,000 gift to an institution and directs that the fund should be accumulated until its value reaches $1,500, the historic dollar value will increase from $1,000 to $1,500.

Other than pursuant to these specific rules, historic dollar value does not change. Historic dollar value is not reduced as a fund incurs expenses, nor is it increased as the fund value increases, even if the organization decides to retain fund appreciation for any number of reasons, including to retain the original purchase power of the fund.[66]

Note that a donor could make a gift to a charitable organization that is only partially an endowment fund. For example, if a donor makes a grant of $1,000 for use for a specific purpose with the direction that $500 of such gift be retained in perpetuity, then $500 of such gift creates an endowment fund subject to UMIFA, the historic dollar value of which is $500. The other $500 portion of the gift may be currently expended on the purpose designated by the donor.

As discussed above, the language authorizing appropriation of net appreciation for expenditure in Section 2 of UMIFA is qualified in that only so much of such appreciation "as is prudent under the standard established by Section 6" may be appropriated. Section 6 establishes a standard of ordinary business care and prudence, requiring that the governing board of an organization "exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision."[67]

In exercising such care and prudence, UMIFA specifically requires consideration of the "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."[68] Thus, notwithstanding the fact that UMIFA embraces a total

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[66] As discussed below, an institution may decide that it is prudent to retain fund appreciation in order to retain the original purchase power of the fund. Nonetheless, if it were to so decide, the actual historic dollar value of the fund as that term is defined in UMIFA would not change.
[67] UMIFA §6.
[68] *Id.*

return concept allowing for expenditure of net appreciation on investment assets, the governing board of the organization must determine whether it is prudent to expend that appreciation, considering the specifically-enumerated factors, and may not expend the appreciation if it determines that to do so would be imprudent.[69]

This standard of care was selected specifically to subject boards of directors of not-for-profit organizations to a standard comparable to that of directors of business corporations and not that of private trustees.[70] It was derived from the standard of care applicable to managers of private foundations set forth in United States Proposed Treasury Regulations in the context of the prohibition on jeopardy investments introduced by the 1969 Tax Reform Act.[71]

It is important to recognize that UMIFA's scope is limited in that it only seeks to provide default rules for the expenditure of endowment fund appreciation. In other words, if a donor does not expressly state otherwise in making an endowment fund gift, Section 2 of UMIFA governs, authorizing the expenditure of net appreciation in excess of the historic dollar value of the endowment fund. However, amounts in excess of appreciation may be available for expenditure if permissible "under other law, the terms of the applicable gift instrument, or the charter of the institution."[72]

For example, if a donor makes an endowment fund contribution of $1,000, and specifies in the gift instrument that $100 from such fund may be expended each year for five years, then the institution holding such fund is authorized to make an appropriation of $100 for expenditure in the first year. This is true even if the fund has not appreciated by $100 and even if the appropriation takes the fund below the value of the initial contribution establishing the fund. If, under this hypothetical, the assets in which the $1,000 endowment fund is invested enjoy a 5% return in the first year, the fund will have

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[69] The "ordinary business care and prudence" standard is discussed further below in this paper.
[70] *See* UMIFA Cmt. to § 6.
[71] Prop. Treas. Reg. § 53.4944-1(a)(2)(i). These regulations are now in final form. These regulations also moved from the consideration of each investment to looking at a particular investment in the context of the portfolio as a whole. *Id.*
[72] UMIFA §2. I have not yet come across any corporate charter that provides that endowment funds may be spent down. It is an interesting issue whether such a provision would trump a more restrictive gift instrument, especially if the donor were not aware of the charter provision. According to verbal advice given by the New York Attorney General's office, a charter of a New York not-for-profit corporation with language of this sort would not trump a more restrictive gift instrument if the donor were unaware of it.

increased in value to $1,050. After the $100 annual expenditure appropriation, the fund's value will be $950, which is $50 lower than its initial value, yet this expenditure is not in violation of Section 2 of UMIFA, since it is specifically authorized in the gift instrument.[73]

An organization also may be subject to rules that are more strict than the default rule set forth in Section 2 of UMIFA. Section 3 of UMIFA states that Section 2 "does not apply if the applicable gift instrument indicates the donor's intention that net appreciation shall not be expended." Additionally, Section 3 states that:

> [a] restriction upon the expenditure of net appreciation may not be implied from a designation of a gift as an endowment, or from a direction or authorization in the applicable gift instrument to use only "income," "interest," "dividends," or "rents, issues or profits," or "to preserve the principal intact," or a direction which contains other words of similar import.[74]

This language is not intended to allow for expenditure of appreciation contrary to donor intent but rather is a "rule of construction" in light of the fact that gift instruments may contain language that is a holdover from the private trust law area, but which does not in fact express actual donor intent.[75] Thus, if a gift instrument states that "only income" may be expended, net appreciation may nonetheless be expended under the default rule, due to the rule of construction in Section 3. However, if the gift instrument explicitly says, "net appreciation may not be expended," then the UMIFA default rule allowing for expenditure of net appreciation set forth in Section 2 would be overwritten.

4. <u>Investment Management and Delegation</u>

In addition to permitting the expenditure of appreciation and adopting the "ordinary business care and prudence" standard of care, UMIFA also grants broad investment authority to investment managers of endowment funds in any investments

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[73] Even though the full $1000 gift is subject to restrictions on expenditure, it is not clear that the historic dollar value should be $1000. Since the fund may be reduced by $100 each year and thus may fall below $1000, it would not make sense to set the historic dollar value at $1000. On the other hand, if the initial historic dollar value were $1000, perhaps that amount would be reduced, each year by $100. This would not seem to comport with the definition of historic dollar value in UMIFA which does not appear to allow for any downward adjustments. UMIFA § 1(5). Hence, the historic dollar value may have to be set at $500.

[74] UMIFA §3.

[75] See comment to UMIFA §3, 7A U.L.A. at pp. 493-494. I question whether, if asked, a donor's "intent" when creating an endowment fund would include the expenditure of all appreciation.

"otherwise authorized by law or the applicable gift instrument."[76] Further, UMIFA specifically authorizes investments in real property, mortgages and partnerships and allows for investment of endowment funds in investment pools held by either the institution itself or third parties (such as mutual funds, REITs, partnership funds, etc.).[77] In creating such broad authority, the drafters specifically sought to distinguish the rules applicable to managers of endowment funds from those applicable to private trust fiduciaries.[78]

Additionally, as discussed above, trust fiduciaries were generally precluded from delegating investment management. UMIFA makes a clean break with this aspect of private trust law, permitting boards of directors to delegate investment authority not only to officers, committees and employees of the organization, but also to third-party investment advisors and managers.[79] In meeting its duty of care, the board that delegates investment management is left with the responsibility for overall investment policy and "selection of competent agents."[80]

5. The Adoption of UMIFA by the States

Since its promulgation by the NCCUSL, UMIFA has been adopted by every state other than Alaska, Arizona, Pennsylvania and South Dakota, and by the District of Columbia.[81] Although Florida enacted UMIFA, it repealed it effective January 7, 2003. As early as 1973, an advisory opinion to the New Hampshire legislature affirmed the constitutionality of the application of a UMIFA-based statute to an endowment fund existing prior to adoption of the statute.[82]

Not every state that has adopted UMIFA, however, has adopted it verbatim. In Alabama, for example, the UMIFA-based statute that was originally adopted was

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[76] UMIFA § 4.
[77] *Id.*
[78] *See* UMIFA Prefatory Note, "Specific Investment Authority."
[79] UMIFA § 5.
[80] *See* UMIFA, Cmt. to § 5. UMIFA also contains provisions permitting the release of donor-imposed restrictions on endowment fund assets. *See* UMIFA § 7. Although Section 7 explicitly does not limit application of the *cy pres* doctrine, it provides a statutory framework for seeking donor consent for a release of a restriction or, if the board has no means of access to the donor (e.g., if the donor has died), for making application for the release of a restriction in the courts. *Id.*
[81] State adoptions are listed at the legislative fact sheet with respect to UMIFA on the Uniform Law Commissioners website at: http://www.nccusl.org.
[82] *Opinion of the Justices,* 306 A.2d 55 (N.H. 1973).

applicable only to educational institutions. As of September 1, 2002, the statute applies more broadly. The UMIFA-based statute adopted in New York included a significant change to Section 2 of UMIFA. Like UMIFA, New York Not-for-Profit Corporation Law ("N-PCL") §513(c) permits expenditure of unrealized net appreciations with respect to readily marketable assets, but it diverges from UMIFA in that it prohibits the expenditure of unrealized appreciation with respect to non-readily marketable assets.[83]

The versions of Section 2 of UMIFA adopted in Massachusetts, New Mexico and New Hampshire state that the appropriation by an institution of net appreciation for expenditure in any year in an amount greater than 7% of the average fair market value of the endowment funds over at least the last 12 quarters creates a rebuttable presumption of imprudence on the part of the governing board of that institution.

The UMIFA-based statute adopted in Rhode Island adopts the historic dollar value concept and uses a definition of historic dollar value essentially the same as the UMIFA definition. However, it sets the historic dollar value of every endowment fund in existence in that state at the time the statute was enacted at the fair market value of the fund on either May 4, 1972 or, at the discretion of the organization, on the last day of either of the past two fiscal years of the organization. Thus, for endowment funds that had been in existence in that state for quite some time prior to 1972, or for funds that had otherwise enjoyed significant appreciation, a substantial amount of appreciation was locked into the historic dollar value. Finally, in the statute adopted in Rhode Island, historic dollar value must be adjusted to preserve the original purchase power of the endowment fund.[84]

Because of the considerable variation amongst the states, [85] it goes without saying that governing boards of charitable institutions must consider carefully the specific state laws applicable to their institutions. Corporations formed in one state but qualified to do business in another state and holding endowment funds in that state may be subject to the laws of both states. Additionally, multi-state organizations with individual corporate

[83] This divergence is discussed more fully in Part III, below.
[84] This aspect of the Rhode Island statute is discussed more fully in Part III, below.
[85] This discussion is by no means an exhaustive one of all of the variations amongst the states that have adopted UMIFA-based statutes.

entities in more than one state must carefully consider the applicable laws of several states at once. In interpreting provisions of versions of UMIFA adopted in the states, authority discussing the analogous provisions of UMIFA, for example, in the NCCUSL's prefatory notes to UMIFA, is often consulted, although it is doubtful that such guidance could be relied on as binding authority in any state.

C. The Modernization of the Trust Law – The 1980s and 1990s.

UMIFA went a long way toward liberalizing the investment rules applicable to charitable corporations. The standard of "ordinary business care and prudence under the facts and circumstances prevailing at the time" of the decision was considered much less restrictive than the standard applicable to trustees.[86] Additionally, the power to delegate investment management went a long way toward modernizing investment management for charitable boards of directors.

In 1987 the American Law Institute began a process of revising the Restatement of Trusts in order to make the standard of care required by trust fiduciaries more consistent with modern investment practice, and, in 1992, the Third Restatement of Trusts was released.[87] As pointed out by Professor Langbein, several states, including Iowa and Georgia, had already revised and modernized their prudent investor statutes prior to the national law project.[88]

In 1991, NCCUSL began a project to codify the Restatement's prudent investing principles as the Uniform Prudent Investor Act (the "Act"), which was promulgated in 1994. Although the Act emerges from private trust law, it is of direct relevance to charitable organizations. As discussed below, NCCUSL later incorporated the standard of care set forth in the Act into the Uniform Principal and Income Act, which sets forth rules governing the allocation of trust asset investment return to income on the one hand and

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[86] The common understanding is that this standard absolves a board from all but gross negligence while the standard applicable to trustees holds them to a test of negligence. There is very little authority to support this distinction.

[87] John H. Langbein, "The Uniform Prudent Investor Act and the Future of Trust Investing," 81 Iowa L. Rev. 641 (March 1996).

[88] *Id.* at 641, *citing* Iowa Code Ann. § 633.123 (West 1992), Ga. Code Ann. § 53-8-2(c).

principal on the other, and, at least as adopted by many states, is applicable to charitable trusts.

1. <u>Uniform Prudent Investor Act</u>

The prudent investor rule described in the Act shifts the focus of the prudence analysis shifts from results to process. Rather than the standard being a "prudent man" standard, the standard is one of the "prudent investor." More specifically, the investment range in which prudence is analyzed expands, portfolio diversification is emphasized, and trustees are permitted to delegate investment responsibility to a responsible professional. Taken in turn, the first significant change arises from analyzing prudence in the context of the entire investment portfolio, rather than scrutinizing individual decisions.[89] This is a marked change from the old standard and interpretations thereof, pursuant to which individual investments could be classified as imprudent. Second, the trustee should focus on the appropriate balance between risk and return, as dictated by the elements of the trust and the needs of the beneficiaries.[90] When forming an investment plan, the trustee is expected to consider various financial and social implications, such as economic conditions, tax consequences, the beneficiary's relationship to trust assets, the need for liquidity and the desire for capital.[91] The risk and return strategy should be "reasonably suited" to the trust.[92] Significantly, the Act states that no investment is barred categorically.[93] Instead, the Act requires that the trustee determine if an investment is worth its risk in the context of the entire portfolio. As a well-balanced portfolio is a *sine qua non* of a modern investment portfolio, the Act incorporates diversification into the concept of prudence, with narrow exceptions.[94]

Finally, while outdated trust law prohibited a trustee from delegating responsibility, because s/he was expected to serve the beneficiaries as the settlor had intended, the Act

[89] The Act, §2.
[90] *Id.*
[91] *Id.*
[92] *Id.*
[93] The Act, §2(e).
[94] The exceptions noted in the official comments include when tax benefits dictate retaining already-existing trust assets or when a family business is placed in trust. Outside of these exceptions, diversification is critical. The Act, §3.

permits delegation, while specifying oversight procedures.[95] In this scheme, investment and management tasks that a similarly-situated prudent trustee could delegate may be delegated, but the trustee remains under a duty of care and caution in selecting and supervising the agent. A trustee with special skills, however, or who presents her/himself as having special skills, has a duty to use those skills.[96] So a trustee cannot delegate important responsibilities s/he could perform as well as the agent.

Additional responsibilities include reviewing the trust's assets within a reasonable time of accepting a trusteeship to decide which investments to maintain and which to sell;[97] observing the duty of loyalty so that the trustee acts exclusively on behalf of the trust beneficiaries;[98] and acting impartially toward two or more trust beneficiaries, such that neither is favored.[99]

Like other elements of trust law, the prudent investor standard codified in the Act is a default rule that can be altered by the trust instrument. The primary application of the Act is to private family trusts, but it also influences responsibilities of charitable and pension trustees because, as the Restatement notes, "the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust." Transitively, the prudent investor standard in the Act also informs expectations of directors and officers of charitable corporations because their duties are "generally similar to the duties of the trustee of a charitable trust."[100] This is an interesting statement and is an articulation that NCCUSL believes the Act goes further toward liberalizing the investment rules applicable to trust trustees than did UMIFA for corporate directors.

The Act has been adopted in substantially similar form in more than 30 states.[101] A few states have made significant modifications. For example, Minnesota omitted the section requiring trustees to manage and invest trust assets impartially if there are two or

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[95] The Act, §9.
[96] The Act, §2(f). This is a limitation on delegation power which is not articulated in UMIFA. Further, the trustee must ensure the trust is not being charged by an agent for services the trustee was expected to perform. If so, the trustee's fee should be lowered accordingly.
[97] The Act, §4.
[98] The Act, §5.
[99] The Act, §6.
[100] The Act, Prefatory Note.
[101] Sally Whitney, *Prudent Investor Spotlights Needs-Based Planning, at* http://www.tonysteuer.com/Articles/ADutyToAdvise.pdf.

more trust beneficiaries[102] and Arkansas inserted a presumption against delegation of trustee responsibilities to a single agent.[103] Both New York and California adopted versions of the Act[104] that each include certain variations, but which retain the same overall intent. [105]

2. Uniform Principal and Income Act of 1997: Trust Law's Long-Awaited Modernization

The Uniform Principal and Income Act (the "UPIA") was first approved in 1931, with a second draft endorsed roughly thirty years later. These acts addressed broad issues concerning the administration of assets held in trust or as part of an estate.[106] These earlier incarnations did not, however, address total return spending, and maintained the classic private trust law strict bifurcation between earned income, i.e., interest, dividends, rents and royalties, on the one hand and principal, or corpus (including appreciation), on the other. These earlier incarnations also incorporated a standard of care imposed on trustees that eventually was considered to be antiquated, particularly after the 1994 adoption of the Uniform Prudent Investor Act.[107]

In 1997, NCCUSL adopted a new version of UPIA that moved away from the strict distinction between income and principal and specified how particular types of assets and earnings are to be treated for purposes of income and principal rules given the ever expanding investment options.

UPIA embraces the notion in modern portfolio theory that appreciation should be available for expenditure within certain limitations. Recall that UMIFA, which allows for expenditure of appreciation so long as it is prudent to do so, maintains a strict bifurcation between appreciation on the one hand and historic dollar value on the other. UPIA

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[102] UNIFORM LAWS ANNOTATED: BUSINESS AND FINANCIAL LAWS 301 (West, 2000).
[103] UNIFORM LAWS ANNOTATED: BUSINESS AND FINANCIAL LAWS 306 (West, 2000).
[104] *See* N.Y. EST. POWERS & TRUSTS § 11-2.1 and Cal. Prob. Code § 16045-16054.
[105] Both New York and California omitted the section on the duty of loyalty to the beneficiary and California also omitted the section about the duty of impartiality when there are two or more beneficiaries. *See* N.Y. EST. POWERS & TRUSTS LAW § 11-2.1 and Cal. Prob. Code § 16045-16054. Neither of these modifications have any impact for purely charitable trusts.
[106] These issues included the distribution of income earned during the probate of an estate, allocation between principal and income at the start, and through to the end, of an income interest, and determining the appropriate recipient of income where, upon the end of an income interest, income is either undistributed, or accrued but unreceived. UPIA, Pref. Note, 7B U.L.A. 131, 133 (1977).
[107] See Part IV, below, for a discussion of the evolving applicable standards of care.

arguably goes further than UMIFA, granting trustees the discretion to adjust between the principal and income of funds held in trust provided that certain conditions are met. This provision is contained in §104(a). It states that:

> A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages the trust as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in Section 103(a), that the trustee is unable to comply with Section 103(b). [108]

The purpose behind the power to adjust is to "enable a trustee to select investments using the standards of the prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest, dividends, and rents."[109] Also consistent with the prudent investor rule and modern portfolio theory, "the power to adjust…is to be exercised by considering net income from the portfolio as a whole and not investment by investment."[110]

One commentator explains that UPIA's language concerning the degree of adjustment permitted can be read both narrowly or liberally. The narrow reading is that the discretion is limited to the difference "in trust income resulting from the trustee's investment decisions." [111] The liberal reading is that the discretion is as broad as might be required "to promote fair sharing of total return."[112] As with the power to expend appreciation authorized by UMIFA, the power to adjust in Section 104(a) of UPIA is a default rule that applies to trust administration, unless the terms of the trust clearly indicate an intent to deny the power.[113] Significantly, the definition of "terms of the trust" for purposes of UPIA authorizes the trustee to look beyond the actual language of the trust

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[108] UPIA § 104(a). In addition to adjustments pursuant to §104, UPIA permits transfers from income to principal in two other circumstances. With some exceptions, a trustee can transfer to principal a "reasonable amount of the net cash receipts from a principal asset that is subject to depreciation." As with the power to adjust, this power to transfer is discretionary and requires compliance with §103(b). UPIA also permits transfers from income to reimburse principal.
[109] UPIA § 104, cmt. at 143.
[110] *Id.* at 145 (quoting Restatement of Trusts 3d: Prudent Investor Rule §227, Comment *i*).
[111] See Lyman V. Welch, "Brave New World of Total Return Laws," *Trusts and Estates* 24, 26 (June 2002).
[112] *Id.*
[113] UPIA § 104(f).

and also consider "the manifestation of the intent of a settlor or decedent with respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or spoken words or by conduct."[114] The commentary in the Uniform Laws Annotated states that the trust instrument "should specifically refer to the power to adjust if the settlor intends to forbid its use."[115] (This provision is similar to Section 3 of UMIFA regarding the need for a donor to state explicitly that appreciation may not be expended.)

The power to adjust is applicable to charitable trusts, but only so long as "both income and principal are . . . set aside for charitable purposes."[116] In other words, UPIA applies to trusts that hold charitable assets and where income and principal are both used solely for charitable purposes. However, UPIA does not apply to trusts, such as charitable lead or remainder trusts, where a non-charitable person is a beneficiary.[117]

A condition to the discretionary power to adjust is that the trustee must "invest[ ] and manage[ ] trust assets as a prudent investor ...."[118] In this regard, the trustees must consider a series of factors, to the extent they are relevant. These factors are:

> (1) the nature, purpose, and expected duration of the trust;
>
> (2) the intent of the settlor;
>
> (3) the identity and circumstances of the beneficiaries;
>
> (4) the needs for liquidity, regularity of income, and preservation and appreciation of capital;
>
> (5) the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;

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[114] UPIA § 102(12). This arguably permits a broader look at settlor intent than is afforded under UMIFA to donor intent.
[115] See Comment to § 104(f) of UPIA.
[116] UPIA § 104(c)(4).
[117] It should be remembered that both charitable lead and charitable remainder trusts are governed by explicit provisions of federal tax law regarding the determination of income interests and any deviation would cause adverse tax consequences.
[118] UPIA §104(a).

> (6) the net amount allocated to income under the other sections of this [Act] and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;
>
> (7) whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;
>
> (8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and
>
> (9) the anticipated tax consequences of an adjustment.

The majority of the above-listed factors derive from the Uniform Prudent Investor Act §§2(c) and 3, discussed above.[119] The goal of this integration was to ensure that "comparable factors will apply to investment decisions and decisions involving the power to adjust."[120]

Along with its focus on adjustment between income and principal, UPIA provides additional guidance for trustees to distinguish between principal and income and attempts to deal with this allocation in light of the types of investment vehicles now available to investment managers.[121]

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[119] UPIA §104, cmt. at 145. Factors (b)(3)- (b)(4), (b)(6) and (b)(8) originate from UPIA §2(c); (b)(5) originates from UPIA § 3.

[120] *Id.* UPIA also enumerates eight instances when a trustee is barred from exercising the power of adjustment. Seven of the eight address tax implications. UPIA § 104(c). The first four aim to "preserve tax benefits that may have been an important purpose for creating the trust," and three others concern avoiding adverse tax consequences.

[121] For example, property other than cash distributed to a trust by an entity in which the trust holds an investment is treated as principal. UPIA §401(c)(1). Further, derivatives and options held as part of an investment portfolio are generally characterized as principal. UPIA §414.

3. Adoption of the Act by the States – Equitable Adjustment and Unitrust Conversion

Since approval of UPIA in 1997, the majority of states and the District of Columbia have passed some form of total return legislation applicable to trusts.[122] Typically one of two schemes is adopted.[123] The first, termed "equitable adjustment," essentially tracks UPIA and allows discretionary adjustment between income and principal.[124] The second is a unitrust model, which permits a trustee to "convert an income trust to a unitrust.[125] Such conversion "changes the definition of income for the trust, substituting a distributable amount determined as a percentage of trust assets revalued at least annually."[126] Both methods are in accordance with the total return model in that they allow income and remainder beneficiaries to "share as partners in the total investment results," thereby freeing the trustee from rigid investment allocation requirements.[127]

D. Revisions to UMIFA – The Demise of Historic Dollar Value? – Developments in the 21st Century

The power of adjustment under UPIA is of primary relevance in the private trust context. What is important about UPIA is that it has now gone further in many ways than UMIFA in granting discretion to fiduciaries. As of the time of writing this article, NCCUSL is considering promulgating a significantly revised version of UMIFA and a committee has begun the redrafting process ("Revised UMIFA").[128] Although the current

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[122] State adoptions of UPIA are listed at the legislative fact sheet with respect to UPIA on the Uniform Law Commissioners website at: http://www.nccusl.org.

[123] *See* Welch, "Brave New World of Total Return Laws," *supra* note 111 at 24. Some state legislation combines the two models. Welch's article enumerates five different schemes potentially available to the trustee under the equitable adjustment approach, and notes that just as all equitable adjustment schemes incorporate §104(a) verbatim, they also include UPIA's definition of "terms of the trust," which relates to impartiality.

[124] *Id.*

[125] *Id. See also* Joel C. Dobris, in "Real Return, Modern Portfolio Theory, and College, University, and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules," 28 REAL PROPERTY, PROBATE AND TRUST JOURNAL 49, n.20 (1993). Dobris describes a unitrust as a trust that "draws no distinction between income and principal, and a set percentage of asset value is paid out annually in lieu of income" (*citing* BLACK'S LAW DICTIONARY 1534 (6th ed. 1990)).

[126] *Id.*

[127] *Id.* Pennsylvania, which has not adopted a UMIFA-based statute, allows Pennsylvania not-for-profit corporations to adopt a total-return spending policy that is essentially a unitrust model. *See* 15 Pa.C.S. § 5548(c) (2003).

[128] The most recent April, 2003 version of this draft may be obtained at www.nccusl.org.

draft is by no means final, the draft contains several significant changes from the current UMIFA. First, it explicitly applies to charitable trusts. Second, it abandons the concept of historic dollar value. Finally, it incorporates the standard of care set forth in the Act that was later incorporated into UPIA.

1. Charitable Trusts.

As discussed above, UMIFA does not clearly state its applicability to charitable trusts, leading to some confusion. Many states have adopted UMIFA as part of their not-for-profit corporate law, thus not extending it explicitly to trusts.[129] Further, there is some question as to the applicability of UPIA to charitable, as opposed to private, trusts (although several states that have adopted UPIA, apply its terms to charitable trusts).

In my opinion, it makes no sense to apply different laws to the maintenance of charitable assets held in trust on the one hand or by a corporation on the other.[130] The distinction between the two types of entities can have an impact, because courts at time have adhered to the formalistic distinction between the two organizational forms.[131] As the Delaware Supreme Court stated, "the creator of a charitable enterprise recognizes that different legal rules govern . . . and selects a form with those rules in mind."[132]

The Revised UMIFA defines an "Institution," to which the act applies as "any nonprofit corporation, trust, unincorporated association, government or governmental subdivision or agency or any other legal entity organized and operated for [charitable

[129] *See, e.g.,* the New York Not-for-Profit Corporation Law, § 511 et seq.

[130] As mentioned above, as early as 1960, Professor Kenneth Karst pointed out the illogic of applying different rules and standards to the two forms of organization, calling for a "law of charities." *See* Karst, "The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility," *supra* note 1 at 436.

[131] *See Oberly v. Kirby,* 592 A.2d 445, 466-67 (Del. Sup. Ct. 1991), *cited in* Evelyn Brody, "The Limits of Charity Fiduciary Law," *supra* note 17 at 1416.

[132] *Id.* Professor Evelyn Brody has suggested that this "selection" process may not be as deliberate as the Delaware Supreme Court suggests, noting that, "[i]n practice, it must be admitted, rarely does the founder of a charity carefully consider the legal difference and make a choice based on the advantages of organizational form." *Id.* Brody in fact notes that the preference for the corporate form in the United States is in fact partly a "historical accident," and numerous factors, including "normative pressures," such as the "professional training of the charity advisor (particularly attorneys)," lead to the vast majority of charities being organized in corporate form. While I agree with this latter statement that there is a tendency to favor the corporate form, my experience has been that founders and their advisors frequently consider the advantages or disadvantages of one form of organization over the other.