

BOARD OF REGENTS
BRIEFING PAPER

1. Agenda Item Title: Endowment Policy Change

2. BACKGROUND & POLICY CONTEXT OF ISSUE:

Board of Regents' Handbook Title 4, Chapter 10, Section 4, 3c, adopted the Uniform Management of Institutional Act (UMIFA) as guidelines for the Endowment spending policy. The National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Prudent Management of Institutional Funds Act (UPMIFA) which replaced the UMIFA, and recommended it for enactment by the legislatures of the various states. The State of Nevada passed SB 70, adopting the UPMIFA, effective October 1, 2007.

3. SPECIFIC ACTIONS BEING RECOMMENDED OR REQUESTED:

Amend Board of Regents' Handbook Title 4, Chapter 10, Section 4, 3c, and adopt UPMIFA.

4. IMPETUS (WHY NOW?):

To be in compliance with SB70, which is effective October 1, 2007.

5. BULLET POINTS TO SUPPORT REQUEST/RECOMMENDATION:

Provides guidance and authority concerning the management and investment of certain funds, including endowments.
The new Act provides modern articulations of the prudence standards for the management and investment of charitable funds and for endowment spending.

6. POTENTIAL ARGUMENTS AGAINST THE REQUEST/RECOMMENDATION:

None

7. ALTERNATIVE(S) TO WHAT IS BEING REQUESTED/RECOMMENDED:

8. COMPLIANCE WITH BOARD POLICY:

Consistent With Current Board Policy: Title #____ Chapter #____ Section #____
Amends Current Board Policy: Title #__4_ Chapter #__10 Section #__4, 3c
Amends Current Procedures & Guidelines Manual: Chapter #____ Section #____
Other: _____
Fiscal Impact: Yes____ No____
Explain: _____

POLICY PROPOSAL
TITLE 4, CHAPTER 10, SECTION 4, 3C
Endowment Distribution Policy

Additions appear in **boldface underlined**; deletions are [~~stricken~~ and bracketed]

c. The spending policy shall be administered by the Banking and Investment Office in accordance with the [~~Uniform Management of Institutional Funds Act~~] **Uniform Prudent Management of Institutional Funds Act**, adopted by the Regents, [~~on August 30, 1984~~] in accordance with the authority granted to them by *Nevada Revised Statutes (NRS) 396.380* and *NRS 396.420* to control and invest the System's funds. (B/R 10/98)



strategy and objectives of the fund. Investment experts, whether in-house or hired for the purpose, are held to a standard of care consistent with that expertise.

UMIFA initiated the era of modern portfolio management for charitable institutions. UPMIFA provides the standards and guidelines that subsequent experience tells us are the most appropriate for the purpose. Charitable institutions will have more precise standards to guide them. Courts will have more precise standards with which to measure prudence in the event of a challenge. The result should be more money for programs supported by charitable funds, including endowments.

EXPENDITURE

UMIFA initiated the concept of total return expenditure of endowment assets for charitable program purposes, expressly permitting prudent expenditure of both appreciation and income and replacing the old trust law concept that only income (e.g., interest and dividends) could be spent. Thus, asset growth and income could be appropriated for program purposes, subject to the rule that a fund could not be spent below "historic dollar value."

UPMIFA builds upon UMIFA's rule on appreciation, but it eliminates the concept of "historic dollar value." UPMIFA, instead, provides better guidance on prudence and makes the need for a floor on spending unnecessary. UPMIFA states that the institution "may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines to be prudent for the uses, benefits, purposes and duration for which the endowment fund is established." Seven criteria guide the institution in its yearly expenditure decisions: "1) duration and preservation of the endowment fund; 2) the purposes of the institution and the endowment fund; 3) general economic conditions; 4) effect of inflation or deflation; 5) the expected total return from income and the appreciation of investments; 6) other resources of the institution; and, 7) the investment policy of the institution." These standards mirror the standards that apply to 01 Tw T[i4-J]TToi lowmd[mosrhalf th3ifyunne0.0008Tc 0.0001 Tw T[i9.93Td(d)5(bt be hTw T[i4-Jthe nditure d



UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT

drafted by the

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

and by it

APPROVED AND RECOMMENDED FOR ENACTMENT
IN ALL THE STATES

at its

ANNUAL CONFERENCE
MEETING IN ITS ONE-HUNDRED-AND-FIFTEENTH YEAR
HILTON HEAD, SOUTH CAROLINA

July 7-14, 2006

WITH PREFATORY NOTE AND COMMENTS

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By

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

October 10, 2006

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**DRAFTING COMMITTEE ON UNIFORM PRUDENT MANAGEMENT OF
INSTITUTIONAL FUNDS ACT**

The Committee appointed by and representing the National Conference of Commissioners on Uniform State Laws in drafting this Act consists of the following individuals:

BARRY C. HAWKINS, 300 Atlantic St., Stamford, CT 06901, *Chair*

JOHN P. BURTON, P.O. Box 1357, 315 Paseo de Peralta, Santa Fe, NM 87501

MARY JO HOWARD DIVELY, Carnegie Mellon University, 5000 Forbes Ave., Pittsburgh, PA 15213

L.S. JERRY KURTZ, JR., 1050 Beech Ln., Anchorage, AK 99501

SHELDON F. KURTZ, University of Iowa, College of Law, 446 BLB, Iowa City, IA 52242

JOHN H. LANGBEIN, Yale Law School, P.O. Box 208215, New Haven, CT 06520 -8215

JOHN J. MCAVOY, 3110 Brandywine St. NW, Washington, DC 20008

MATTHEW S. RAE, JR., 520 S. Grand Ave., 7th Floor, Los Angeles, CA 90071-2645

GLEE S. SMITH, P.O. Box 667, Lawrence, KS 66044

SUSAN N. GARY, University of Oregon, School of Law, 1515 Agate St., Eugene, OR 97403,
Reporter

EX OFFICIO

HOWARD J. SWIBEL, 120 S. Riverside Plaza, Suite 1200, Chicago, IL 60606, *President*

TOM BOLT, Corporate Place, 5600 Royal Dane Mall, St. Thomas, VI 00802-6410, *Division
Chair*

AMERICAN BAR ASSOCIATION ADVISORS

CAROL G. KROCH, Rodney Square North, 1100 Market St., Wilmington, DE 19890, *ABA
Advisor*

JOHN K. NOTZ, JR., 191 N. Wacker Dr., Chicago, IL 60606-1698, *ABA Section Advisor*

CYNTHIA ROWLAND, One Ferry Building, Suite 200, San Francisco, CA 94111, *ABA Section
Advisor*

EXECUTIVE DIRECTOR

WILLIAM H. HENNING, University of Alabama School of Law, Box 870382, Tuscaloosa, AL 35487-0382, *Executive Director*

Copies of this Act may be obtained from:
NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS
211 E. Ontario Street, Suite 1300
Chicago, Illinois 60611
312/915-0195
www.nccusl.org

UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT

UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT

Prefatory Note

Reasons for Revision. The Uniform Prudent Management of Institutional Funds Act (UPMIFA) replaces the Uniform Management of Institutional Funds Act (UMIFA). The National Conference of Commissioners on Uniform State Laws approved UMIFA in 1972, and 47 jurisdictions have enacted the act. UMIFA provided guidance and authority to charitable organizations within its scope concerning the management and investment of funds held by those organizations, UMIFA provided endowment spending rules that did not depend on trust accounting principles of income and principal, and UMIFA permitted the release of restrictions on the use or management of funds under certain circumstances. The changes UMIFA made to the law permitted charitable organizations to use modern investment techniques such as total-return investing and to determine endowment fund spending based on spending rates rather than on determinations of “income” and “principal.”

UMIFA was drafted almost 35 years ago, and portions of it are now out of date. The prudence standards in UMIFA have provided useful guidance, but prudence norms evolve over time. The new Act provides modern articulations of the prudence standards for the management and investment of charitable funds and for endowment spending. The Uniform Prudent Investor Act (UPIA), an Act promulgated in 1994 and already enacted in 43 jurisdictions, served as a model for many of the revisions. UPIA updates rules on investment decision making for trusts, including charitable trusts, and imposes additional duties on trustees for the protection of beneficiaries. UPMIFA applies these rules and duties to charities organized as nonprofit corporations. UPMIFA does not apply to trusts managed by corporate and other fiduciaries that are not charities, because UPIA provides management and investment standards for those trusts.

In applying principles based on UPIA to charities organized as nonprofit corporations, UPMIFA combines the approaches taken by UPIA and by the Revised Model Nonprofit Corporation Act (RMNCA). UPMIFA reflects the fact that standards for managing and investing institutional funds are and should be the same regardless of whether a charitable organization is organized as a trust, a nonprofit corporation, or some other entity. *See* Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule 7* (1986) (stating “[t]he modern paradigm of prudence applies to all fiduciaries who are subject to some version of the prudent man rule, whether under ERISA, the private foundation provisions of the Code, UMIFA, other state statutes, or the common law.”); Harvey P. Dale, *Nonprofit Directors and Officers - Duties and Liabilities for Investment Decisions*, 1994 N.Y.U. Conf. Tax Plan. 501(c)(3) Org’s. Ch. 4.

UPMIFA provides guidance and authority to charitable organizations concerning the management and investment of funds held by those organizations, and UPMIFA imposes additional duties on those who manage and invest charitable funds. These duties provide additional protections for charities and also protect the interests of donors who want to see their contributions used wisely.

UMIFA did not articulate these requirements.

Thus, UPMIFA strengthens the rules governing management and investment decision making by charities and provides more guidance for those who manage and invest the funds.

Donor Intent with Respect to Endowments. UPMIFA improves the protection of donor intent with respect to expenditures from endowments. When a donor expresses intent clearly in a written gift instrument, the Act requires that the charity follow the donor's instructions. When a donor's intent is not so expressed, UPMIFA directs the charity to spend an amount that is prudent, consistent with the purposes of the fund, relevant economic factors, and the donor's intent that the fund continue in perpetuity. This approach allows the charity to give effect to donor intent, protect its endowment, assure generational equity, and use the endowment to support the purposes for which the endowment was created.

Retroactivity. Like UMIFA, UPIA, the Uniform Principal and Income Act of 1961, and the Uniform Principal and Income Act of 1997, UPMIFA applies retroactively to institutional funds created before and prospectively to institutional funds created after enactment of the statute. Regarding the considerations motivating this treatment of the issues, see the comment to Section 4.

Endowment Spending. UPMIFA improves the endowment spending rule by eliminating the concept of historic dollar value and providing better guidance regarding the operation of the prudence standard. Under UMIFA a charity can spend amounts above historic dollar value that the charity determines to be prudent. The Act directs the charity to focus on the purposes and needs of the charity rather than on the purposes and perpetual nature of the fund. ThDr[(ardinC

simply as a direction to preserve historic dollar value, the charity may spend more than it should.

3. The Act does not provide clear answers to questions a charity faces when the value of an endowment fund drops below historic dollar value. A fund that is so encumbered is commonly called an “underwater” fund. Conflicting advice regarding whether an organization could spend from an underwater fund has led to difficulties for those managing charities. If a charity concluded that it could continue to spend trust accounting income until a fund regained its historic dollar value, the charity might invest for income rather than on a total-return basis. Thus, the historic dollar value rule can cause inappropriate distortions in investment policy and can ultimately lead to a decline in a fund’s real value. If, instead, a charity with an underwater fund continues to invest for growth, the charity may be unable to spend anything from an underwater endowment fund for several years. The inability of a charity to spend anything from an endowment is likely to be contrary to donor intent, which is to provide current benefits to the charity.

The Drafting Committee concluded that providing clearly articulated guidance on the prudence rule for spending from an endowment fund, with emphasis on the permanent nature of the fund, would provide the best protection of the purchasing power of endowment funds.

Presumption of Imprudence. UPMIFA includes as an optional provision a presumption of imprudence if a charity spends more than seven percent of an endowment fund in any one year. The presumption is meant to protect against spending an endowment too quickly. Although the Drafting Committee believes that the prudence standard of UPMIFA provides appropriate and adequate protection for endowments, the Committee provided the option for states that want to include a mechanical guideline in the statute. A major drawback to any statutory percentage is that it is unresponsive to changes in the rate of inflation or deflation.

Modification of Restrictions on Charitable Funds. UPMIFA clarifies that the doctrines of cy pres and deviation apply to funds held by nonprofit corporations as well as to funds held by charitable trusts. Courts have applied trust law rules to nonprofit corporations in the past, but the Drafting Committee believed that statutory authority for applying these principles to nonprofit corporations would be helpful. UPMIFA permitted release of restrictions but left the application of cy pres uncertain. Under UPMIFA, as under trust law, the court will determine whether and how to apply cy pres or deviation and the attorney general will receive notice and have the opportunity to participate in the proceeding. The one addition to existing law is that UPMIFA gives a charity the authority to modify a restriction on a fund that is both old and small. For these funds, the expense of a trip to court will often be prohibitive. By permitting a charity to make an appropriate modification, money is saved for the charitable purposes of the charity. Even with respect to small, old funds, however, the charity must notify the attorney general of the charity’s intended action. Of course, if the attorney general has concerns, he or she can seek the agreement of the charity to change or abandon the modification, and if that fails, can commence a court action to enjoin it. Thus, in all types of modification the attorney general continues to be the protector both of the donor’s intent and of the public’s interest in charitable funds.

Other Organizational Law. For matters not governed by UPMIFA, a charitable organization will continue to be governed by rules applicable to charitable trusts, if it is organized as a trust, or rules applicable to nonprofit corporations, if it is organized as a nonprofit corporation.

Relation to Trust Law. Although UPMIFA applies a number of rules from trust law to institutions organized as nonprofit corporations, in two respects UPMIFA creates rules that do not exist under the common law applicable to trusts. The endowment spending rule of Section 4 and the provision for modifying a small, old fund in subsection (d) of Section 6 have no counterparts in the common law or the UTC. The Drafting Committee believes that these rules could be useful to charities organized as trusts, and the Committee recommends conforming amendments to the UTC and the Principal and Income Act to incorporate these changes into trust law.

UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT

SECTION 1. SHORT TITLE. This [act] may be cited as the Uniform Prudent Management of Institutional Funds Act.

SECTION 2. DEFINITIONS. In this [act]:

(1) “Charitable purpose” means the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of a governmental purpose, or any other purpose the achievement of which is beneficial to the community.

(2) “Endowment fund” means an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment fund for its own use.

(3) “Gift instrument” means a record or records, including an institutional solicitation, under which property is granted to, transferred to, or held by an institution as an institutional fund.

(4) “Institution” means:

(A) a person, other than an individual, organized and operated exclusively for charitable purposes;

(B) a government or governmental subdivision, agency, or instrumentality, to the extent that it holds funds exclusively for a charitable purpose; and

(C) a trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated.

(5) “Institutional fund” means a fund held by an institution exclusively for charitable purposes. The term does not include:

(A) program-related assets;

(B) a fund held for an institution by a trustee that is not an institution; or

(C) a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund.

(6) “Person” means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, public corporation, government or governmental subdivision, agency, or instrumentality, or any other legal or commercial entity.

(7) “Program-related asset” means an asset held by an institution primarily to accomplish a charitable purpose of the institution and not primarily for investment.

(8) “Record” means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

Comment

Subsection (1). Charitable Purpose. The definition of charitable purpose follows that of UTC § 405 and Restatement (Third) of Trusts § 28 (2003). This long-familiar standard derives from the English Statute of Charitable Uses, enacted in 1601.

Some 17 states have created statutory definitions of charitable purpose for various purposes. *See, e.g.*, 10 PA. CONS. STAT. § 162.3 (2005) (defining charitable purpose within the Solicitation of Funds for Charitable Purposes Act to include “humane,” “patriotic,” social welfare and advocacy,” and “civic” purposes). The definition in subsection (1) applies for purposes of this Act and does not affect other definitions of charitable purpose.

Subsection (2). Endowment Fund. An endowment fund is an institutional fund or a part

individual funds and cannot be applied to a group of funds that may be managed collectively for investment purposes.

Board-designated funds are institutional

portfolio. The collective fund makes annual distributions to the individual funds based on the units held by each fund. For purposes of Section 3 [and Section 5], the collective fund is considered one institutional fund. Section 4 and Section 6 apply to each fund individually and not to the collective fund.

Assets held by an institution primarily for program-related purposes rather than exclusively for investment are not subject to UPMIFA. For example, a university may purchase land adjacent to its campus for future development. The purchase might not meet prudent investor standards for commercial real estate, but the purchase may be appropriate because the university needs to build a new dormitory. The classroom buildings, administration buildings, and dormitories held by the university all have value as property, but the university does not hold those buildings as financial assets for investment purposes. The Act excludes from the prudent investor norms those assets that a charity uses to conduct its charitable activities, but does not exclude assets that have a tangential tie to the charitable purpose of the institution but are held primarily for investment purposes.

A fund held by an institution is not an institutional fund if any beneficiary of the fund is not an institution. For example, a charitable remainder trust held by a charity as trustee for the benefit of the donor during the donor's lifetime, with the remainder interest held by the charity, is not an institutional fund. However, this subsection treats as an institution a charitable remainder trust that continues to operate for charitable purposes after the termination of the noncharitable interests. The Act will have only a limited effect on a charitable remainder trust that terminates after the noncharitable interest ends. During the period required to complete the distribution of the trust's property, the prudence norm will apply to the actions of the trustee, but

inner-city businesses may be “primarily to accomplish a charitable purpose of the institution” but also can be considered, in part, an investment. The institution should create reasonable credit standards and other guidelines for the program to increase the likelihood that the loans will be repaid.

Subsection (8). Record. This definition was added to clarify that the definition of instrument includes electronic records as defined in Section 2(8) of the Uniform Electronic Transactions Act (1999).

SECTION 3. STANDARD OF CONDUCT IN MANAGING AND INVESTING INSTITUTIONAL FUND.

(a) Subject to the intent of a donor expressed in a gift instrument, an institution, in managing and investing an institutional fund, shall consider the charitable purposes of the institution and the purposes of the institutional fund.

(b) In addition to complying with the duty of loyalty imposed by law other than this [act], each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.

(c) In managing and investing an institutional fund, an institution:

(1) may incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution; and

(2) shall make a reasonable effort to verify facts relevant to the management and investment of the fund.

(d) An institution may pool two or more institutional funds for purposes of management and investment.

(1) In managing and investing an institutional fund, the following factors, if relevant, must be considered:

- (A) general economic conditions;
- (B) the possible effect of inflation or deflation;
- (C) the expected tax consequences, if any, of investment decisions or strategies;
- (D) the role that each investment or course of action plays within the overall investment portfolio of the fund;
- (E) the expected total return from income and the appreciation of investments;
- (F) other resources of the institution;
- (G) the needs of the institution and the fund to make distributions and to preserve capital; and
- (H) an asset's special relationship or special value, if any, to the charitable purposes of the institution.

(2) Management and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution.

(3) Except as otherwise provided by law other than this [act], an institution may invest in any kind of property or type of investment consistent with this section.

(4) An institution shall diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification.

(5) Within a reasonable time after receiving property, an institution shall make and carry out decisions concerning the retention or disposition of the property or to rebalance a portfolio, in order to bring the institutional fund into compliance with the purposes, terms, and distribution requirements of the institution as necessary to meet other circumstances of the institution's needs. (6) An institution that has a professional skills or

making investments and considering the risk to diversify investments abs]60 a concluskills or 9 19.14elc 0.m60 ngand unleon

judgment standard under corporate law, *as applied to charitable institutions*. That is, a manager operating a charitable organization under the business judgment rule would look to the same factors as those identified by the prudent investor rule. The standard for prudent investment set forth in Section 3 first states the duty of care as articulated in the RMNCA, but provides more specific guidance for those managing and investing institutional funds by incorporating language from UPIA. The criteria derived from UPIA are consistent with good practice under current law applicable to nonprofit corporations.

Trust law norms already inform managers of nonprofit corporations. The Preamble to UPIA explains: “Although the Uniform Prudent Investor Act by its terms applies to trusts and not to charitable corporations, the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations.” *See also*, Restatement (Third) of Trusts: Prudent Investor Rule § 379, Comment b, at 190 (1992) (stating that “absent a contrary statute or other provision, the prudent investor rule applies to investment of funds held for charitable corporations.”). Trust precedents have routinely been found to be helpful but not binding authority in corporate cases.

The Drafting Committee decided that by adopting language from both the RMNCA and UPIA, UPMIFA could clarify that common standards of prudent investing apply to all charitable institutions. Although the principal trust authorities, UPIA § (2)(a), Restatement (Third) of Trusts §337, UTC § 804, and Restatement (Second) of Trusts § 174 (prudent administration) use the phrase “care, skill and caution,” the Drafting Committee decided to use the more familiar corporate formulation as found in RMNCA. The standard also appears in Sections 3, 4 and 5 of UPMIFA. The Drafting Committee does not intend any substantive change to the UPIA standard and believes that “reasonable care, skill, and caution” are implicit in the term “care” as used in the RMNCA. The Drafting Committee included the detailed provisions from UPIA, because the Committee believed that the greater precision of the prudence norms of the Restatement and UPIA, as compared with UMIFA, could helpfully inform managers of charitable institutions. For an explanation of the Prudent Investor Act, see John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 Iowa L. Rev. 641 (1996), and for a discussion of the effect UPIA has had on investment decision making, see Max M. Schanzenbach & Robert H. Sitkoff, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?*, 50 J. L. & Econ. (forthcoming 2007).

Section 3 has incorporated the provisions of UPIA with only a few exceptions. UPIA applies to private trusts and is entirely default law. The settlor of a private trust has complete control over virtually all trust provisions. See UTC § 105. Because UPMIFA applies to charitable organizations, UPMIFA makes the duty of care, the duty to minimize costs, and the duty to investigate mandatory. The duty of l

for which decisions are being made. These factors are specific to charitable organizations; UPIA § 2(a) states the duty to consider similar factors in the private trust context.

UPMIFA does not include the duty of impartiality, stated in UPIA § 6, because nonprofit corporations do not confront the multiple beneficiaries problem to which the duty is addressed. Under UPIA, a trustee must treat the current beneficiaries and the remainder beneficiaries with due regard to their respective interests, subject to alternative direction from the trust document. A nonprofit corporation typically creates one charity. The institution may serve multiple beneficiaries, but those beneficiaries do not have enforceable rights in the institution in the same way that beneficiaries of a private trust do. Of course, if a charitable trust is created to benefit more than one charity, rather than being created to carry out a charitable purpose, then UPIA will apply the duty of impartiality to that trust.

In other respects, the Drafting Committee made changes to language from UPIA only where necessary to adapt the language for charitable institutions. No material differences are intended. Subsection (e)(1)(D) of Section 3 of UPMIFA does not include a clause that appears at the end of UPIA § 2(c)(4) (“which may include financial assets, interest in closely held enterprises, tangible and intangible personal property, and real property.”). The Drafting Committee deemed this clause unnecessary for charitable institutions. The language of subsection (e)(1)(G) reflects a modification of the language of UPIA § (2)(c)(7). Other minor modifications to the UPIA provisions make the language more appropriate for charitable institutions.

The duties imposed by this section apply to those who govern an institution, including directors and trustees, and to those to whom the directors or managers delegate responsibility for investment and management of institutional funds. The standard applies to officers and employees of an institution and to agents who invest and manage institutional funds. Volunteers who work with an institution will be subject to the duties imposed here, but state and federal statutes may provide reduced liability for persons who act without compensation. UPMIFA does not affect the application of those shield statutes.

Subsection (a). Donor Intent and Charitable Purposes. Subsection (a) states the overarching duty to comply with donor intent as expressed in the terms of the gift instrument.

interests of the corporation.” RMNCA § 8.30. The trust law articulation of the loyalty standard uses “sole interests” rather than “best interests.” As the Restatement of Trusts explains, “[t]he trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary.” Restatement (Second) of Trusts § 170 (1). Although the standards for loyalty, like the standard of care, are merging, *see* Evelyn Brody, *Charitable Governance: What’s Trust Law Got to do With It?*

institution should consider the institution's mission, its current programs, and the desire to cultivate additional donations from a donor, in addition to factors related more directly to the asset's potential as an investment.

Subsection (e)(1)(C) reflects the fact that some organizations will invest in taxable investments that may generate unrelated business taxable income for income tax purposes.

Assets held primarily for program-related purposes are not subject to UPMIFA. The management of those assets will continue to be governed by other laws applicable to the institution. Other assets may not be held primarily for program-related purposes but may have both investment purposes and program-related purposes. Subsections (a) and (e)(1)(H) indicate that a prudent decision maker can take into consideration the relationship between an investment and the purposes of the institution and of the institutional fund in making an investment that may have a program-related purpose but not be primarily program-related. 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.

Subsection (e)(2). Portfolio Approach. This subsection reflects the use of portfolio theory in modern investment practice. The language comes from UPIA § 2(b), which follows the articulation of the prudent investor standard in Restatement (Third) of Trusts: Prudent Investor Rule § 227(a) (1992).

Subsection (e)(3). Broad Investment Authority. Consistent with the portfolio theory of investment, this subsection permits a broad range of investments. The language derives from UPIA § 2(e).

Section 4 of UMIFA indicated that an institution could invest "without restriction to investments a fiduciary may make." The committee removed this language from subsection (e)(3) as unnecessary, because states no longer have legal lists restricting fiduciary investing to the specific types of investments identified in statutory lists.

Subsection (e)(3) also provides that other law may limit the authority under this subsection. In addition, all of subsection (e) is subject to contrary provisions in a gift instrument, and a gift instrument may restrict the ability to invest in particular assets. For example, the gift instrument for a particular institutional fund might preclude the institution from investing the assets of the fund in companies that produce tobacco products.

In her book, *Governing Nonprofit Organizations: Federal and State Law and Regulation* 434 (Harv. Univ. Press 2004), Marion R. Fremont-Smith reports that some large charities pledge their endowment funds as security for loans. Subsection (e)(3) permits this sort of debt financing, subject to the guidelines of subsection (e)(1).

Subsection (e)(4). Duty to Diversify. This subsection assumes that prudence requires diversification but permits an institution to determine that nondiversification is appropriate under exceptional circumstances. A decision not to diversify must be based on the needs of the charity

area of expertise, simply because the board member is lawyer. *See* ALI Principles of the Law of Nonprofit Organizations, Preliminary Draft No. 3 (May 12, 2005) § 315 (Duty of Care), cmt. c.

UMIFA contained two provisions that authorized investments in pooled or common investment funds. UMIFA §§ 4(3), 4(4). The Drafting Committee concluded that Section 3(e)(3) of UPMIFA authorizes these investments. The decision not to include the two provisions in UPMIFA implies no disapproval of such investments.

**SECTION 4. APPROPRIATION FOR EXPENDITURE OR ACCUMULATION
OF ENDOWMENT FUND; RULES OF CONSTRUCTION.**

(a) Subject to the intent of a donor expressed in the gift instrument [and to subsection (d)], an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. Unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution. In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following factors:

- (1) the duration and preservation of the endowment fund;
- (2) the purposes of the institution and the endowment fund;
- (3) general economic conditions;
- (4) the possible effect of inflation or deflation;
- (5) the expected total return from income and the appreciation of investments;
- (6) other resources of the institution; and
- (7) the investment policy of the institution.

(b) To limit the authority to appropriate for expenditure or accumulate under subsection (a), a gift instrument must specifically state the limitation.

(c) Terms in a gift instrument designating a gift as an endowment, or a direction or authorization in the gift instrument to use only “income”, “interest”, “dividends”, or “rents, issues, or profits”, or “to preserve the principal intact”, or words of similar import:

(1) create an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund; and

(2) do not otherwise limit the authority to appropriate for expenditure or accumulate under subsection (a).

[(d) The appropriation for expenditure in any year of an amount greater than seven percent of the fair market value of an endowment fund, calculated on the basis of market values determined at least quarterly and averaged over a period of not less than three years immediately preceding the year in which the appropriation for expenditure was made, creates a rebuttable presumption of imprudence. For an endowment fund in existence for fewer than three years, the fair market value of the endowment fund must be calculated for the period the endowment fund has been in existence. This subsection does not:

(1) apply to an appropriation for expenditure permitted under law other than this [act] or by the gift instrument; or

(2) create a presumption of prudence for an appropriation for expenditure of an amount less than or equal to seven percent of the fair market value of the endowment fund.]

Comment

Purpose and Scope of Revisions. This section revises the provision in UMIFA that permitted the expenditure of appreciation of an endowment fund to the extent the fund had

Subsection (a). Expenditure of Endowment Funds. Subsection (a) uses the RMNCA articulation of the standard of care for decision making under Section 4. The change in language does not reflect a substantive change. The comment to Section 3 more fully describes that standard of care.

Section 4 permits expenditures from an endowment fund to the extent the institution determines that the expenditures are prudent after considering the factors listed in subsection (a). These factors emphasize the importance of the intent of the donor, as expressed in a gift instrument. Section 4 looks to written documents as evidence of donor's intent and does not require an institution to rely on oral expressions of intent. By requiring written evidence of intent, the Act protects reliance by the donor and the institution on the written terms of a donative agreement. Informal conversations may be misremembered and may be subject to multiple interpretations. Of course, oral expressions of intent may guide an institution in further carrying out a donor's wishes and in understanding a donor's intent.

The factors in subsection (a) require attention to the purposes of the institution and the endowment fund, economic conditions, and present and reasonably anticipated resources of the institution. As under UMIFA, determinations under Section 4 do not depend on the characterization of assets as income or principal and are not limited to the amount of income and unrealized appreciation. The authority in Section 4 is permissive, however, and an institution organized as a trust may continue to make spending decisions under trust accounting principles so long as doing so is prudent.

Institutions have operated effectively under UMIFA and have operated more conservatively than the historic dollar value rule would have permitted. Institutions have little incentive to maximize allowable spending. Good practice has been to provide for modest expenditures while maintaining the purchasing power of a fund. Institutions have followed this practice even though UMIFA (1) does not require an institution to maintain a fund's purchasing power and (2) does allow an institution to spend any amounts in a fund above historic dollar value, subject to the prudence standard. The Drafting Committee concluded that eliminating historic dollar value and providing institutions with more discretion would not lead to depletion of endowment funds. Instead, UPMIFA should encourage institutions to establish a spending policy that will be responsive to short-term fluctuations in the value of the fund. Section 4 allows an institution to 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 an institution may appropriately make expenditures even if a fund has not generated investment return that year.

Several levels of safeguard exist to prevent an institution from depleting an endowment fund or diverting assets from the purposes for which the fund was created. In comparison with

clarifies that in making spending decisions the institution should attempt to ensure that the value of the fund endures while still providing that some amounts be spent for the purposes of the endowment fund. In UPMIFA prudent decision making emphasizes the endowment aspect of the fund, rather than the overall purposes or needs of the institution.

In addition to the guidance provided by Section 4, other safeguards exist. Donors can restrict gifts and can provide specific instructions to donee institutions regarding appropriate uses for assets contributed. Within institutions, fiduciary duties govern the persons making decisions on expenditures. Those persons must operate both with the best interests of the institution in mind and in keeping with the intent of donors. If an institution diverts an institutional fund from the charitable purposes of the institution, the state attorney general can enforce the charitable interests of the public. By relying on these safeguards while providing institutions with adequate discretion to make appropriate expenditures, the Act creates a standard that takes into consideration the diversity of the charitable sector. The committee expects that accumulated experience with such spending formulas will continue to inform institutional practice under the Act.

Distinguishing Legal and Accounting Standards. Deleting historic dollar value does not transform any portion of an endowment fund into unrestricted assets from a legal standpoint. An endowment fund is restricted because of the donor's intent that the fund be restricted by the prudent spending rule, that the fund not be spent in the current year, and that the fund continue to maintain its value for a long time. Regardless of the treatment of endowment fund from an accounting standpoint, legally an endowment fund should not be considered unrestricted. Subsection (a) states that endowment funds will be legally restricted until the institution appropriates funds for expenditure. The UMIFA statutes in Utah and Maine contain similar language. 13 Me. Rev. Stat. Ann. tit. 13 § 4106 (West 2005); Utah Code Ann. 1953 § 13-29-3 (2005). *See, also*, advisory published by Mass. Attorney General, "The Attorney General's Position on FASB Statement of Financial Accounting Standards No. 117, ¶ 22 and Related G.L.C. 180A Issues" (January 2004) <http://www.ago.state.ma.us/filelibrary/fasb.pdf> (last visited May 22, 2006) (concerning the treatment of endowments as legally restricted assets).

The term "endowment fund" includes funds that may last in perpetuity but also funds that are created to last for a fixed term of years or until the institution achieves a specified objective. Section 4 requires the institution to consider the intended duration of the fund in making determinations about spending. For example, if a donor directs that a fund be spent over 20 years, Section 4 will guide the institution in making distribution decisions. The institution would amortize the fund over 20 years rather than try to maintain the fund in perpetuity. 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.

Subsection (c). Rule of Construction. Donor's intent must be respected in the process of making decisions to expend endowment funds. Section 4 does not allow an institution to convert an endowment fund into a non-endowment fund nor does the section allow the institution to ignore a donor's intent that a fund be maintained as an endowment. Rather, subsection (c)

assumes that if a donor wants an institution to spend “only the income” from a fund, the donor intends that the fund both support current expenditures and be preserved permanently. The donor is unlikely to be concerned about designation of particular returns as “income” or “principal” under accounting principles. Rather the donor is more likely to assume that the institution will use modern total-return investing techniques to generate enough funds to distribute while maintaining the long-term viability of the fund. Subsection (c) is an intent effectuating provision that provides default rules to construe donor’s intent.

As subsection (b) explains, a donor who wants to specify particular spending guidelines can do so. For example, a donor might require that a charity spend between three and five percent of an endowed gift each year, regardless of investment performance or other factors. Because the charity agrees to the restriction in accepting the gift, the restriction will govern spending decisions by the charity. Another donor might want to limit expenditures to trust accounting income and not want the institution to be able to expend appreciation. An instruction to “pay only the income” will not be specific enough, but an instruction to “pay only interest and dividend income earned by the fund and not to make other distributions of the kind authorized by Section 4 of UPMIFA” should be construed to mean “pay only interest and dividend income earned by the fund and not to make other distributions of the kind authorized by Section 4 of UPMIFA.”

doing so spend more than is prudent, without adequate review of the prudence factors as required under the Act.

Perhaps the biggest problem with including a presumption in the statute is the difficulty of picking a number that will be appropriate in view of the range of institutions and charitable purposes and the fact that economic conditions will change over time. Under recent economic conditions, a spending rate of seven percent is too high for most funds, but in a period of high inflation, seven percent might be too low. In making a prudent decision regarding how much to spend from an endowment fund, each institution must consider a variety of factors, including the particular purposes of the fund, the wishes of the donors, changing economic factors, and whether the fund will receive future donations.

Whether or not a statute includes the presumption, institutions must remember that prudence controls decision making. Each institution must make decisions on expenditures based on the circumstances of the particular charity.

Application of Presumption.

for fundraising. The value of a fund, as calculated for purposes of determining the seven percent amount, will reflect increases due to contributions and investment gains and decreases due to distributions and investment losses. The seven percent figure includes charges for fundraising and administrative expenses other than investment management expenses. All costs or fees associated with an endowment fund are factors that prudent decision makers consider. High costs or fees of investment management could be considered imprudent regardless of whether spending exceeds seven percent of the fund's value.

The presumption of imprudence does not create an automatic safe harbor. Expenditures at six percent might well be imprudently high. See James P. Garland, *The Fecundity of Endowments and Long-Duration Trusts*, *The Journal of Portfolio Management* (2005). Evidence reviewed by the Drafting Committee suggests that at present few funds can sustain spending at a rate above five percent. See Roger G. Ibbotson & Rex A. Sinquefeld, *Stocks, Bonds, Bills, and Inflation: Historical Returns (1926-1987)* (Research Foundation of the Institute of Chartered Financial Analysts, 1989). Indeed, under current conditions five percent can be too high. See Joel C. Dobris, *Why Five? The Strange, Magnetic, and Mesmerizing Affect of the Five Percent Unitrust and Spending Rate on Settlers, Their Advisers, and Retirees*, 40 *Real Prop. Prob. & Tr. J.* 39 (2005). Further, spending at a lower rate, particularly in the early years of an endowment, may result in greater distributions over time. See DeMarche Associates, Inc, *Spending Policies and Investment Planning for Foundations: A Structure for Determining a Foundation's Asset Mix* (Council on Foundations: 3d ed. 1999). 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 permanently, the institution should take special care to limit annual spending to a level that protects the purchasing power of the fund.

Subsection (d) provides that the terms of the gift instrument can provide additional spending authority. For example, if a gift instrument directs that an institution expend a fund over a ten-year period, exhausting the fund after ten years, spending at a rate higher than seven percent will be necessary.

Subsection (d) does not require an institution to spend a minimum amount each year. The prudence standard and the needs of the institution will supply sufficient guidance regarding whether to accumulate rather than to spend in a particular year.

Spending above seven percent in any one year will not necessarily be imprudent. For some endowment funds fluctuating spending rates may be appropriate. Although the Act does not apply the percentage for the presumption on a rolling basis (e.g., 21 percent over three years), some endowment funds may prudently spend little or nothing in some years and more than seven percent 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 percent of the value of the fund for construction costs. The decision to accumulate in years one through three and then to spend 20 percent in the fourth year 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 decision-making process in the fourth year to be able to meet the burden of production associated with the presumption. Another charity might

prudently spend 20 percent in year one and nothing for the following three years. That charity would also need to document the decision-making process through which the decision to spend occurred and maintain records explaining why the decision was prudent under the circumstances.

A 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 such a fund will likely fluctuate, with limited expenditures in some years and big expenditures in others. The fund would not exhibit a uniform spending rate. Indeed, an advantage of a capital replacement fund is the 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 five percent per year but would vary, with spending in some years more and in some years less. Even if this fund is an endowment fund subject to Section 4, spending above seven percent in a particular year could well be prudent. Subsection (d) does not preclude spending above seven percent.

A charity creating a capital replacement fund or a building fund might choose to adopt spending rules for the fund that would not be subject to UPMIFA. Specific donor intent can supersede the rules of UPMIFA. If the charity creates a gift instrument that establishes appropriate rules on spending for the fund, and if donors agree to those restrictions, then the UPMIFA rules on spending, including the bracketed presumption, will not apply.

Institutions with Limited Investment and Spending Experience. Several attorneys general and other charity officials raised concerns about whether small institutions would be able to adjust to a spending rule based solely on prudence, without the bright-line guidance of historic dollar value. Some charity regulators who spoke with the Drafting Committee noted that large institutions have sophisticated investment strategies, access to good investment advisors, and experience with spending rules that maintain purchasing power for endowment funds. For these institutions, the rules of UPMIFA should work well. For smaller institutions, however, the state regulators thought that additional guidance could be helpful. After discussing strategies to address this concern, the Drafting Committee decided to include in these comments an additional optional provision that a state could choose to include in its UPMIFA statute.

The optional provision focuses on institutions with endowment funds valued, in the aggregate, at less than \$2,000,000. The number is in brackets to indicate that it could be set higher or lower. The number was chosen to address the concern of the state regulators that some small charities might be more likely to spend imprudently than large charities. The Drafting Committee selected \$2,000,000 as the value that might include most unsophisticated institutions but would not be overinclusive.

The optional provision creates a notification requirement for an institution with a small endowment that plans to spend below historic dollar value. If an institution subject to the provision decides to appropriate an amount that would cause the value of its endowment funds to drop below the aggregate historic dollar value for all of its endowment funds, then the institution will have to notify the attorney general before proceeding with the expenditure. The provision does not require that the institution obtain the approval of the attorney general before making the

distribution. Rather, the notification requirement gives the attorney general the opportunity to take a closer look at the institution and its spending decision, to educate the institution on prudent decision making for endowment funds, and to intervene if the attorney general determines that the spending would be imprudent for the institution. Although the Drafting Committee thinks that the prudence standard in UPMIFA provides adequate guidance to all institutions within the scope of the Act, if a state chooses to adopt a notification provision for

(b) In performing a delegated function, an agent owes a duty to the institution to exercise reasonable care to comply with the scope and terms of the delegation.

(c) An institution that complies with subsection (a) is not liable for the decisions or actions of an agent to which the function was delegated.

(d) By accepting delegation of a management or investment function from an institution that is subject to the laws of this state, an agent submits to the jurisdiction of the courts of this state in all proceedings arising from or related to the delegation or the performance of the delegated function.

(e) An institution may delegate management and investment functions to its committees, officers, or employees as authorized by law of this state other than this [act].]

Comment

The prudent investor standard in Section 4 presupposes the power to delegate. For some types of investment, prudence requires diversification, and diversification may best be accomplished through the use of pooled investment vehicles that entail delegation. The Drafting Committee decided to put Section 5 in brackets because many states already provide sufficient authority to delegate authority through other statutes. If such authority exists, then an enacting state should enact UPMIFA without Section 5. Enacting delegation rules that duplicate existing rules could be confusing and might create conflicts. For charitable trusts, UPIA provides the same delegation rules as those in Section 5. For nonprofit corporations, nonprofit corporation statutes often provide comparable rules. A state enacting UPMIFA must be certain that its laws authorize delegation, either through other use the delegator

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protects decision makers who comply with the requirement for proper delegation from liability for actions or decisions of the agents. In making decisions concerning delegation, the institution must be mindful of Section 3(c)(1) of UPMIFA, the provision that directs the institution to incur only reasonable costs in managing and investing an institutional fund.

Section 5 does not address issues of internal delegation and potential liability for internal delegation, and subsection (c) does not affect laws that govern personal liability of directors or trustees for matters outside the scope of Section 5. Directors will look to nonprofit corporation laws for these rules, while trustees will look to trust law. *See, e.g.*, RMNCA, § 8.30(b) (permitting directors to rely on information prepared by an officer or employee of the institution if the director reasonably believes the officer or employee to be reliable and competent in the matters presented).

(b) The court, upon application of an institution, may modify a restriction contained in a gift instrument regarding the management or investment of an institutional fund if the restriction has become impracticable or wasteful, if it impairs the management or investment of the fund, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund. The institution shall notify the [Attorney General] of the application, and the [Attorney General] must be given an opportunity to be heard. To the extent practicable, any modification must be made in accordance with the donor's probable intention.

(c) If a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund becomes unlawful, impracticable, impossible to achieve, or wasteful, the court, upon application of an institution, may modify the purpose of the fund or the restriction on the use of the fund in a manner consistent with the charitable purposes expressed in the gift instrument. The institution shall notify the [Attorney General] of the application, and the [Attorney General] must be given an opportunity to be heard.

(d) If an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution, [60 days] after notification to the [Attorney General], may release or modify the restriction, in whole or part, if:

- (1) the institutional fund subject to the restriction has a total value of less than [\$25,000];
- (2) more than [20] years have elapsed since the fund was established; and
- (3) the institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument.

Comment

Section 6 expands the rules on releasing or modifying restrictions that are found in Section 7 of UMIFA. Subsection (a) restates the rule from UMIFA allowing the release of a restriction with donor consent. Subsections (b) and (c) make clear that an institution can always

notify donors of the proposed modification. Good practice dictates notifying any donors who are alive and can be located with a reasonable expenditure of time and money. Consistent with the doctrine of deviation under trust law, the institution must notify the attorney general who may choose to participate in the court proceeding. The attorney general protects donor intent as well as the public's interest in charitable assets. Attorney general is in brackets in the Act because in some states another official enforces the law of charities.

Subsection (c). Cy Pres. Subsection (c) applies the rule of cy pres from trust law, authorizing the court to modify the purpose of an institutional fund. The term “modify” encompasses the release of a restriction as well as an alteration of a restriction and also permits a court to order that the fund be paid to another institution. A court can apply the doctrine of cy pres only if the restriction in question has become unlawful, impracticable, impossible to achieve, or wasteful. This subsection applies the cy pres doctrine from trust law, UT

scholarships at the institution. In using the authority granted under subsection (d), the institution must determine which alternative use for the fund reasonably approximates the original intent of the donor. The institution cannot divert the fund to an entirely different use. For example, the fund for nursing scholarships could not be used to build a football stadium.

An institution seeking to modify a provision under subsection (d) must notify the attorney general of the planned modification. The institution must wait 60 days before proceeding; the attorney general may take action if the proposed modification appears inappropriate.

Notice to Donors. The Drafting Committee decided not to require notification of donors under subsections (b), (c), and (d). The trust law rules of equitable deviation and cy pres do not require donor notification and instead depend on the court and the attorney general to protect donor intent and the public's interest in charitable assets.

With regard to subsection (d), the Drafting Committee concluded that an institution should not be required to give notice to donors. Subsection (d) can only be used for an old and small fund. Locating a donor who contributed to the fund more than 20 years earlier may be difficult and expensive. If multiple donors each gave a small amount to create a fund 20 years earlier, the task of locating all of those donors would be harder still. The Drafting Committee concluded that an institution's concern for donor relations would serve as a sufficient incentive for notifying donors when donors can be located.

SECTION 7. REVIEWING COMPLIANCE. Compliance with this [act] is determined in light of the facts and circumstances existing at the time a decision is made or action is taken, and not by hindsight.

SECTION 8. APPLICATION TO EXISTING INSTITUTIONAL FUNDS. This [act] applies to institutional funds existing on or established after [the effective date of this act]. As applied to institutional funds existing on [the effective date of this act] this [act] governs only decisions made or actions taken on or after that date.

SECTION 9. RELATION TO ELECTRONIC SIGNATURES IN GLOBAL AND NATIONAL COMMERCE ACT. This [act] modifies, limits, and supersedes the Electronic Signatures in Global and National Commerce Act, 15 U.S.C. Section 7001 et seq., but does not modify, limit, or supersede Section 101 of that act, 15 U.S.C. Section 7001(a), or authorize

electronic delivery of any of the notices described in Section 103 of that act, 15 U.S.C. Section 7003(b).