The Uniform Prudent Management of Institutional Funds Act

A Much-needed Update to Nonprofit Investment Management Law

By Richard P. Triolo, J.D.

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) was approved and recommended for enactment in all states by the National Conference of Commissioners on Uniform State Laws (NCCUSL) at its annual conference July 7–14, 2006. UPMIFA, which updates the investment management guidelines that apply to institutional funds (including endowment funds) held by charitable institutions, has been adopted in 24 states and the District of Columbia, and has been introduced into legislation in an additional six states including California (Senate Bill 1329). The purpose of this article is to provide a summary of the investment management provisions of UPMIFA as they apply to fiduciaries of nonprofit charitable organizations covered by the law and the investment management consultants who work with them.

UPMIFA is a law that modernizes the investment management guidelines that apply to certain types of nonprofit charitable organizations and funds to include the most recent developments in modern portfolio theory (MPT). UPMIFA is a law whose time has come. This new law is meant to update and replace the Uniform Management of Institutional Funds Act (UMIFA) that was approved by the NCCUSL in 1972 and now is the law in 47 states and the District of Columbia. When UMIFA was adopted it was the first state law that attempted to define a prudent investment process for the fiduciaries responsible for the institutional funds of charitable organizations. UMIFA also created guidelines for the expenditure of endowment funds, including historic dollar value limitations, the concept of total return investing, delegation of investment management responsibilities, releasing restrictions, and a business standard of care for investment decisions. Since that time the tenets of MPT have evolved and expanded to the point where many of the provisions of UMIFA are out of date and need revision.

The Uniform Prudent Investor Act (UPIA), which was approved by the NCCUSL in 1994 and has been adopted in 44 states, served as the model for many of the changes adopted in UPMIFA. The UPIA is the state law that modernized investment management guidelines that apply to fiduciaries of trusts, including charitable trusts, with a corporate or individual trustee. Over the years confusion has developed in the investment community as to which law—UMIFA or UPIA—applies to what type of nonprofit organization and to which assets of the nonprofit. NCCUSL attempted to clarify this question in one of its comments to the UPIA, stating that “[a]lthough the Uniform Prudent Investor Act (UPIA) applies to trusts and not to charitable corporations, the standard of care under UPIA is not limited to trusts.”

To work effectively with clients in these areas, financial advisors need to be aware of the components of the standard of care under UPMIFA to which fiduciaries are held when making investment management decisions. Section 3 of UPMIFA covers that standard of care as it applies to trusts and to charitable corporations. Section 3 of UPMIFA covers that standard of care as it applies to trusts and to charitable corporations.
program-related assets that are held by an institution primarily to accomplish a charitable purpose of the institution and not primarily for investment.

UPMIFA defines the standard of care: "[E]ach 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." In using this language UPMIFA in effect merges the business standard of UMIFA with the updated prudent person standards of the UPIA and creates a unified basis for making investment decisions for charitable funds.

"...A director or trustee who represents himself or herself as having special skills or expertise has a duty to use those skills in managing and investing institutional funds and that person will be held to a higher standard of care."

UPMIFA Section 3
Section 3 also lists the common factors that a fiduciary must consider when making investment decisions:
1. general economic conditions;
2. the possible effect of inflation or deflation;
3. the expected tax consequences, if any, of investment decisions or strategies;
4. the role that each investment or course of action plays within the overall investment portfolio of the fund;
5. the expected total return from income and the appreciation of investments;
6. other resources of the institution;
7. the needs of the institution and the fund to make distributions and to preserve capital; and
8. the asset's special relationship or special value, if any, to the charitable purpose of the institution.

Once these factors are taken into account, UPMIFA permits a fiduciary to invest in any type of property or investment consistent with this section. As to property or investments donated to a charity, an institution must decide to retain or dispose of those assets and rebalance the portfolio within a reasonable time. Although no specific time period is listed in the act, a decision must be made in a timely manner to bring the institution into compliance with the purposes, terms, and distribution requirements of the institution.

As under the UPIA, UPMIFA requires investment decisions to be made not in isolation but in the context of the total portfolio with the risk-and-return objectives suited to both the fund and the institution. As such, UPMIFA applies current MPT standards to investment decision-making for institutional funds.

It should be noted that some but not all of the investment provisions under UPMIFA are subject to the intent of the donor as expressed in the gift instrument. Whereas the UPIA that applies to trusts is entirely default law and is controlled by the settlors' intent, UPMIFA, because it applies to charitable organizations, makes mandatory the duty of loyalty, care, reasonable costs, and verification of facts relevant to the management and investment of the fund. A person managing and investing an institutional fund also must consider the charitable purposes of the institution and of the fund itself. Diversification of investments is required pursuant to MPT guidelines unless the institution reasonably determines that, because of special circumstances such as the stated donor's intent or the desire of the institution to obtain additional contributions from the donor, the fund is better served without diversification. While these factors may be considered, nondiversification would be permitted only under exceptional circumstances.

Fiduciaries also should be aware that under UPMIFA, section 3, subsection (e)(6), any person managing or investing institutional funds must use their own skills, experience, and expertise in carrying out their investment duties. In effect a director or trustee who represents himself or herself as having special skills or expertise has a duty to use those skills in managing and investing institutional funds and that person will be held to a higher standard of care.

UPMIFA Section 4
Section 4 of UPMIFA covers the rules of construction as they apply to the appropriation for expenditure or accumulation of endowment funds. UMIFA allowed an institution to spend only that amount of a restricted endowment fund that was in excess of the fund's historic dollar value. Section 4 of UPMIFA eliminates the historic dollar value limitation of UMIFA and replaces it with a number of factors that the institution should consider in making a decision as to how much of the endowment fund should be spent or retained:
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.

Once again this provision is subject to donor intent as expressed in the gift instrument. If the donor says you can spend only a specific amount, then that
will be the dominant consideration. If, however, the donor says that you can spend only income or that you should retain principal, then this section provides guidelines for the charity to follow in making spending decisions.

One unique provision of section 4 of UPMIFA to be noted by investment professionals is the rebuttable presumption of spending imprudence stated in subsection (d): “The appropriated 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 ... creates a rebuttable presumption of imprudence.” While this provision is optional for states to consider, it is designed to give guidance to fiduciaries as to what is reasonable to spend given normal economic conditions while taking into account the tenets of MPT, including appropriate risk–return characteristics for an endowment fund.

UPMIFA Section 5
Section 5 of UPMIFA authorizes delegation of investment management functions and lists the criteria to which an institution must adhere to do so in a prudent manner: “An institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, in:
1. selecting an agent;
2. establishing the scope and terms of the delegation, consistent with the purposes of the institution and the institutional fund; and
3. periodically reviewing the agent’s actions in order to monitor the agent’s performance and compliance with the scope and terms of the delegation.”

It should be noted that under UPMIFA an institution that complies with the above terms is not liable for the decisions or actions of the agent to which the function was delegated.

UPMIFA Section 6
Section 6, titled “Release or Modification of Restrictions on Management, Investment or Purpose” (of an institutional fund), updates and expands the provisions covering this topic in section 7 of UMIFA. In summary, if an institution wishes to release or modify a donor-created restriction contained in a gift instrument regarding the management or investment of an institutional fund it can always do so if it obtains the consent of the donor. If, however, the donor is deceased and a restriction becomes impracticable, wasteful, or impairs the management or investment of the fund, the institution may petition the court to modify the restriction in order to further the purposes of the fund. Notice must be given to the state attorney general who must be given an opportunity to be heard. If a modification is granted it also must be as close as possible to the donor’s original intent.

Summary
UMIFA, which was approved by the NCCUSL in 1972, has served as a useful guide to nonprofit corporations in the management of their institutional funds. Since UMIFA was drafted, however, a number of its provisions have become obsolete and need to be replaced with the updated rules of MPT. UPMIFA, which endorses the most recent developments in this area, accomplishes that goal as well as serving the needs of nonprofits to make the law governing institutional funds uniform in every state.

States considering the adoption of UPMIFA would be well served to recognize that the new law provides a sound, modern basis for the management of charitable funds. UPMIFA updates and elevates the standard of care provisions of UMIFA as they apply to the management and investment of charitable funds, thus enabling nonprofits to better manage their assets to serve their charitable purposes.

Due to the current regulatory environment and the increased scrutiny at both the federal and state levels, officers and directors of nonprofit organizations are very concerned about their ability to meet their fiduciary investment management responsibilities. As a result, investment management consultants working in this area need to be aware of the provisions of UPMIFA in order to provide appropriate investment management advice and recommendations to their nonprofit clients.

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Endnotes
1 To read the full text of the proposed act, as well as supplementary information and enactment status, visit http://www.upmifa.org.
4 NCCUSL, Uniform Prudent Management of Institutional Funds Act (2006), sec. 3(b). All subsequent citations are to this document.
5 Sec. 3(e)(1).
6 Sec. 4(a).
7 Sec. 4(d).
8 Sec. 5(a).
9 Sec. 5(c).