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BILL ANALYSIS

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Senate Bill 411 (Substitute S-1 as passed by the Senate) *(as enrolled)*
Senate Bill 412 (Substitute S-1 as passed by the Senate) *(as enrolled)*
Sponsor: Senator Michael Switalski (S.B. 411)
Senator Wayne Kuipers (S.B. 412)
Committee: Judiciary

Date Completed: 8-4-09

RATIONALE

The Uniform Management of Institutional Funds Act (UMIFA) governs the investment of funds held by charitable institutions and the expenditure of funds donated as endowments to those institutions. This statute was promulgated in 1972 by the National Conference of Commissioners on Uniform State Laws (NCCUSL) and was adopted by 47 states, including Michigan. At the time, UMIFA was considered a revolutionary advance over prevailing practices, which had relied on trust law for guidance. Subsequently, investment in assets and expenditure for charitable purposes grew exponentially, according to NCCUSL, and asset management theory and practice also evolved. In July 2006, NCCUSL approved the Uniform Prudent Management of Institutional Funds Act (UPMIFA) as a replacement of the 1972 version. To date, 33 states and the District of Columbia have enacted UPMIFA. It has been suggested that Michigan should do so, as well.

CONTENT

Senate Bill 411 (S-1) would enact the "Uniform Prudent Management of Institutional Funds Act" and repeal the Uniform Management of Institutional Funds Act. The proposed Act would do the following:

-- Require an institution managing and investing an institutional fund to consider the institution's charitable purposes and the purposes of the fund.
-- Establish a good faith and prudent person standard for each person responsible for managing and investing an institutional fund.
-- Specify factors that would have to be considered, and rules that would apply, in the management and investment of an institutional fund.
-- Allow an institution to appropriate for expenditure or accumulate amounts of an endowment fund that were prudent for its uses, benefits, purposes, and duration.
-- Require an institution to consider specific factors in determining to appropriate or accumulate amounts in an endowment fund.
-- Specify circumstances under which an institution could delegate the management and investment of an institutional fund to an external agent.
-- Allow an institution or a court to release or modify a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund, under certain circumstances.
-- Require the Attorney General to be notified and given an opportunity to be heard on the matter of releasing or modifying a restriction in a gift instrument.
-- Outline provisions regarding compliance with, and the scope of, the Act.

Senate Bill 412 (S-1) would amend the Nonprofit Corporation Act to refer to the

proposed Uniform Prudent Management of Institutions Funds Act, rather than the Uniform Management of Institutional Funds Act. The bill is tie-barred to Senate Bill 411.

A detailed description of Senate Bill 411 (S-1) follows.

"Institution", "Institutional Fund", & "Charitable Purpose"

Under the proposed Act, "institution" would mean any of the following:

-- A person, other than an individual, organized and operated exclusively for charitable purposes.
-- A government or governmental subdivision, agency, or instrumentality, to the extent that it holds funds exclusively for a charitable purpose.
-- A trust that had both charitable and noncharitable interest, after all noncharitable interest have terminated.

"Institutional fund" would mean a fund held by an institution exclusively for charitable purposes. It would not include any of the following:

-- Program-related assets (those held by an institution primarily to accomplish a charitable purpose and not primarily for investment).
-- A fund held for an institution by a trustee that is not an institution, unless the fund is held by the trustee as a component trust or fund of a community trust or foundation.
-- A fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise on violation or failure of the purposes of the fund.

"Charitable purpose" would mean the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of a governmental purpose, or any other purpose whose achievement is beneficial to the community.

Managing & Investing Institutional Funds

Subject to the donor's intent expressed in a gift instrument, an institution managing and investing an institutional fund would have to consider the institution's charitable purposes and the purposes of the institutional fund. ("Gift instrument" would mean 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.)

In addition to complying with the duty of loyalty imposed by law other than the proposed Act, each person responsible for managing and investing an institutional fund would have to manage and invest it in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. In managing and investing an institutional fund, both of the following would apply:

-- An institution could incur only costs that were appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to it.
-- An institution would have to make a reasonable effort to verify facts relevant to the management and investment of the fund.

An institution could pool two or more institutional funds for purposes of management and investment.

Except as otherwise provided by a gift instrument, in the management and investment of an institutional fund, the following factors, if relevant, would have to be considered:

-- General economic conditions.
-- The possible effect of inflation or deflation.
-- The expected tax consequences, if any, of investment decisions or strategies.
-- The role that each investment or course of action would play within the overall investment portfolio of the fund.
-- The expected total return from income and the appreciation of investments.
-- The institution's other resources.
-- The needs of the institution and the fund to make distributions and to preserve capital.
-- An asset's special relationship or special value, if any, to the charitable purposes of the institution.

In addition, except as otherwise provided by a gift instrument, all of the rules described below would apply.

Management and investment decisions about an individual asset could not be made in isolation but would have to be made 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.

Except as otherwise provided by law other than the proposed Act, an institution could invest in any kind of property or type of investment consistent with Section 3 of the proposed Act (which contains these management and investment requirements).

An institution would have to diversify the investments of an institutional fund unless the institution reasonably determined that, because of special circumstances, the purposes of the fund were better served without diversification.

Within a reasonable time after receiving property, an institution would have to 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 and the requirements of the proposed Act.

A person who had special skills or expertise, or was selected in reliance upon his or her representation that he or she had special skills or expertise, would have the duty to use those skills or that expertise in managing and investing institutional funds.

Appropriation or Accumulation of Endowment Fund

Subject to the intent of a donor expressed in the gift instrument, an institution could appropriate for expenditure or accumulate so much of an endowment fund as the institution determined was prudent for the uses, benefits, purposes, and duration for which the endowment fund was established. ("Endowment fund" would mean an institutional fund or part of an institutional fund that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. It would not include assets that an institution designated as an endowment fund for its own use.)

Unless stated otherwise in the gift instrument, the assets in an endowment fund would be donor-restricted assets until appropriated for expenditure by the institution. In making a determination to appropriate or accumulate, the institution would have to act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and would have to consider, if relevant, all of the following factors:

-- The duration and preservation of the endowment fund.
-- The purposes of the institution and the endowment fund.
-- General economic conditions.
-- The possible effect of inflation or deflation.
-- The expected total return from income and the appreciation of investments.
-- The institution's other resources.
-- The institution's investment policy.

To limit the authority to appropriate for expenditure or accumulate, a gift instrument would have to state the limitation specifically.

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", "rests, issues, or profits", or "to preserve the principal intact", or words of similar import, would create an endowment fund of permanent duration unless other language in the gift instrument limited the duration or purpose of the fund, and would not otherwise limit the authority to appropriate for expenditure or accumulate.

Delegation of Management & Investment

Subject to any specific limitation set forth in a gift instrument or in a law other than the proposed Act, an institution could delegate to an external agent the management and investment of an institutional fund to the extent that an institution could prudently delegate under the circumstances. An institution would have to act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, in doing any of the following:

-- Selecting an agent.

-- Establishing the scope and terms of the delegation, consistent with the purposes of the institution and the institutional fund.
-- Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the scope and terms of the delegation.

An institution that complied with those requirements would not be liable for the decisions or actions of an agent to which the function was delegated.

In performing a delegated function, an agent would owe the institution a duty to exercise reasonable care to comply with the scope and terms of the delegation.

By accepting a delegation of a management or investment function from an institution that was subject to Michigan law, an agent would submit 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.

An institution could delegate management and investment functions to its committees, officers, or employees as authorized by Michigan law other than the proposed Act.

Release or Modification of Donor Restriction

If the donor consented in a record, an institution could release or modify all or part of a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund. A donor could give prior consent to an institution for release or modification of a restriction or charitable purpose in a gift instrument that also included a restriction or stated charitable purpose. A release or modification, however, could not allow a fund to be used for a purpose other than a charitable purpose of the institution.

On application of an institution, a court could modify a restriction contained in a gift instrument regarding the management or investment of an institutional fund if the restriction had become impracticable or wasteful; if it impaired the management or investment of the fund; or if, because of circumstances not anticipated by the donor, a modification of a restriction would further the purposes of the fund. The institution would have to notify the Attorney General of the application, and the Attorney General would have to be given an opportunity to be heard. To the extent practicable, any modification would have to be made in accordance with the donor's probable intention.

If a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund became unlawful, impracticable, impossible to achieve, or wasteful, a court, upon application of an institution, could modify the purpose of the fund or the restriction on its use in a manner consistent with the charitable purposes expressed in the gift instrument. The institution would have to notify the Attorney General, who would have to be given an opportunity to be heard.

If an institution determined that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund was unlawful, impracticable, impossible to achieve, or wasteful, the institution could release or modify all or part of the restriction 60 days after notifying the Attorney General, if all of the following applied:

-- The institutional fund subject to the restriction had a total value of less than $25,000.
-- More than 20 years had elapsed since the fund was established.
-- The institution used the property in a manner consistent with the charitable purposes expressed in the gift instrument.

This section of the proposed Act would not affect the right of an institution's governing body to exercise the power to modify restrictions contained in a gift instrument as conferred by the institution's governing instruments or by a gift instrument.

Compliance with & Scope of the Act

Compliance with the proposed Act would have to be determined in light of the facts and circumstances existing at the time a decision was made or action was taken and not by hindsight.

The Act would apply to institutional funds existing on or established after its effective date. As applied to institutional funds existing on that date, the Act would govern

only decisions made or actions taken on or after that date.

In the application and construction of the proposed Act, consideration would have to be given to the need to promote uniformity of the law with respect to its subject matter among states that enacted it.

The proposed Act would apply only to matters included within the meaning of the terms "institution", "institutional fund", and "person", as defined in the Act. It would not apply to or affect the validity, construction, interpretation, effect, administration, or management of any other trust, estate, or applicable governing instrument.

The proposed Act would modify, limit, and supersede the Electronic Signatures in the Global and National Commerce Act (15 USC 7001 to 7031), but would not modify, limit, or supersede 15 USC 7001(c) or authorize electronic delivery of any of the notices described in 15 USC 7003(b).

(Section 7001 of that Federal statute contains general rules governing the validity of electronic records and signatures. Except as otherwise provided, with respect to any transaction in or affecting interstate or foreign commerce, a signature, contract, or other record relating to the transaction may not be denied legal effect, validity, or enforceability solely because it is in electronic form. Subsection (c) governs consumer disclosure and consent.

Section 7003(b) provides that Section 7001 does not apply to court orders or notices or official court documents required to be executed in connection with court proceedings; documents required to accompany the transportation or handling of toxic or dangerous materials; particular notices pertaining to utility service; actions under a credit agreement secured by, or a rental agreement for, a primary residence; health or life insurance or benefits; or product recall or failure.)

MCL 450.2124 et al. (S.B. 412)

BACKGROUND

History of UPMIFA

According to the National Conference of Commissioners on Uniform State Laws, when it promulgated UMIFA in 1972, there was a great deal of uncertainty about the standards that governed directors of charities operating as nonprofit corporations. Although trust law provided guidance, at that time trust law restricted investment decision-making in a number of ways. Trustees analyzed risk on an asset-by-asset basis, rather than across the portfolio. Since trust law did not permit delegation of investment authority, the involvement of investment advisors caused concern. Also, trust accounting rules defined income and principal in a way that limited investment options.

The 1972 uniform act created a new set of rules to guide charities on the management and investment of funds, provide rules on spending from endowment funds, and permit the release of restrictions on the use and management of charitable funds. These changes permitted charities to use modern investment techniques such as total-return investing, and to determine endowment fund expenditures based on spending rates rather than determinations of "income" and "principal".

After UMIFA was drafted, prudence standards evolved. In 1994, NCCUSL promulgated the Uniform Prudent Investor Rule (UPIR), which updated rules on investment decision-making for trusts, and imposed additional duties on trustees for the protection of beneficiaries. Although it was suggested that the standard articulated in UPIR also governed charities organized as nonprofit corporations, NCCUSL proceeded to update UMIFA to apply the standard explicitly to all charities and make other changes. This led to the promulgation of UPMIFA in 2006.

UMIFA

Under the Uniform Management of Institutional Funds Act, the expenditure of endowment funds is based on the concept of "historic dollar value", which fixes valuation at a moment in time (such as the death of the donor, if a gift is in a will). A charitable institution may spend amounts above historic dollar value (net appreciation) that the charity determines to be prudent. Amounts below historic dollar value may not be spent.

A charitable institution is required to exercise ordinary business care and prudence in making expenditures and investments. Subject to the same standard, an institution may delegate the authority to invest funds. Those making expenditure and investment decisions are directed to focus on the needs of the institution.

With the consent of the donor, an institution may release a restriction placed on the use or investment of an endowment. In addition, the court may order the release of all or part of a restriction. The Act does not address the modification of a restriction.

Michigan adopted UMIFA with the enactment of Public Act 157 of 1976.

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

According to NCCUSL, the statutory rules contained in UMIFA supported two general principals: 1) that assets would be invested prudently in diversified investments that sought growth as well as income, and 2) that appreciation of assets could be spent prudently for the purposes of any endowment fund held by a charitable institution. These fundamental principals are continued in UPMIFA. As an update and successor to the 1972 Act, UPMIFA reflects the experience gained in 35 years under the original statute.

The big change under UPMIFA, according to NCCUSL, comes in the rules on spending from endowment funds contributed by a donor. The original spending rule based on historic dollar value has several deficiencies. Since the moment in time that sets historic dollar value is arbitrary, historic dollar value can vary significantly depending on the market cycle. Also, historic dollar value does not adequately protect a fund that has been in existence for a number of years, assuming reasonable long-term investment success. On the other hand, UMIFA does not clearly address situations in which the value of a fund drops below historic value; evidently, conflicting advice regarding whether an institution may spend from such a fund has led to difficulties for those managing charities. In addition, UMIFA's spending rule focuses on the needs of the charity, rather than the purpose of a particular fund.

The 2006 statute no longer uses the term "historic dollar value" and no longer restricts spending to amounts above that value. Under UPMIFA, a charity may spend the amount it deems prudent after considering the donor's intent and restrictions, the purposes of the fund, and relevant economic factors. This Act emphasizes the perpetuation of the purchasing power of the fund, not just of the original dollars contributed to it. According to NCCUSL, although UPMIFA does not require that a specified amount be set aside as principal, it assumes that a charity will preserve "principal" by maintaining the purchasing power of amounts contributed, and will spend "income" by making a distribution each year using a reasonable spending rate.

Also, the 2006 Act provides stronger guidance for investment management and enumerates a more exact set of rules for investing in a prudent manner, which are closely aligned with the policies applicable to charitable trusts. It requires prudence in incurring investment costs, requires the consideration of expanded factors, and emphasizes that investment decisions must be made in relation to the overall resources of the institution and its charitable purposes. A charitable institution has an affirmative obligation to diversify assets, absent special circumstances. Within a reasonable time after assets come into the possession of the institution, it must review the assets to bring them into conformity with the strategy and objectives of the fund. Investment experts are held to a standard of care consistent with their expertise. By creating more precise standards for charities to guide them, and for courts to measure the exercise of prudence, the Act should result in more money for programs supported by charitable funds.

The prudence standard in UPMIFA reflects the merger of trust and corporate standards when applied to managers of charitable funds, according to NCCUSL. The statute takes language from both the Revised Model Nonprofit Corporation Act and the Uniform Prudent Investor Rule. This includes specific factors a manager should consider and a reminder that donor intent controls. Since prudence is a standard that evolves over

time, UPMIFA updates the statutory language to provide guidance that comports with current best practices.

In addition, UPMIFA clearly authorizes the modification, as well as release, of a donor's restriction on the management, investment, or purpose of an endowment fund, and adopts the doctrine of cy pres (the legal doctrine that the intention of a donor or testator should be carried out as nearly as possible when literal compliance is impossible). Since a charitable institution can continue indefinitely, changing circumstances may necessitate changes in the way the institution carries out its purposes, or changes in the purposes themselves. The 1972 Act permits a charity to release a restriction with the donor's consent, or ask a court to do so, but appears to give the charity control over the assets after the release without the application of cy pres. Under UPMIFA, any change must be consistent with the donor's probable intention. A charity may ask the court to release or modify a restriction that has become impracticable or wasteful or that impairs the management or investment of the fund. A court also may modify a restriction if, because of circumstances not anticipated by the donor, the modification will further the purposes of the fund.

A new provision in UPMIFA allows a charitable institution to release or modify a restriction if a fund is both old (over 20 years) and small (worth less than $25,000). The institution does not need court approval but must notify the attorney general at least 60 days in advance, giving him or her an opportunity to raise concerns or seek an injunction. This provision addresses situations in which a restriction on a fund no longer makes sense but the fund is too small to justify the costs of a court proceeding.

Michigan should enact UPMIFA to modernize the law governing charitable institutions' investment and expenditure of endowment funds. This Act would help ensure that best investment practices were applied; replace obsolete spending rules with a modern rule of prudent expenditure; and encourage the growth of institutional funds. Enacting UPMIFA would make Michigan's statute consistent with the law in the majority of other states, bringing uniformity to the management of institutional funds.

In Michigan-specific language, the bill would make it clear that UPMIFA would apply to charitable endowments but not to charitable trusts, which are governed by the Michigan Trust Code (Article 7 of the Estates and Protected Individuals Code).

Legislative Analyst: Suzanne Lowe

FISCAL IMPACT

The bills would have no fiscal impact on State or local government.

Fiscal Analyst: Elizabeth Pratt
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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.