



**TESTIMONY OF THE STATE ATTORNEY GENERAL
TWENTY-FIFTH LEGISLATURE, 2009**

ON THE FOLLOWING MEASURE:

H.B. NO. 618, S.D. 1, RELATING TO THE UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT.

BEFORE THE:

SENATE COMMITTEE ON JUDICIARY AND GOVERNMENT OPERATIONS

DATE: Thursday, April 2, 2009 **TIME:** 10:15 AM

LOCATION: State Capitol, Room 016

Deliver to: , Room 219, 2 Copies

TESTIFIER(S): WRITTEN TESTIMONY ONLY

(For further information, contact Hugh R. Jones, Deputy Attorney General, at 586-1470.)

Chair Taniguchi and Members of the Committee:

The Department of the Attorney General supports this measure, with the amendment noted below in our written testimony.

The purpose of this bill is to adopt the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). If adopted, UPMIFA would replace the Uniform Management of Institutional Funds Act ("UMIFA") in determining how much an endowment may spend for charitable purposes each year. The adoption of UPMIFA is important because it will allow endowment funds to give away more money.

Presently, the spending of endowment in Hawaii is governed by the Uniform Management of Institutional Funds Act ("UMIFA") (chapter 517D, Hawaii Revised Statutes (HRS)). UMIFA permits the expenditure only of income and a certain percentage of realized or unrealized gain on permanently restricted principal (see section 517D-8, HRS), and requires that the original amount of the gift (the principal or "historic dollar value") be maintained in perpetuity.

When endowment funds are restricted from expending below historic dollar value, and the value of the endowment falls below historic dollar value and does not produce income, the endowment

cannot expend any funds. Due to the current economic conditions, many endowments may be below historic dollar value at this time, which prevents expenditure of funds for critically needed social, public, charitable, and other programs.

In contrast, UPMIFA will allow trustees of charitable endowments to expend principal as well as income, provided that the trustees act in accordance with the standards of prudence set forth in UPMIFA. Under UPMIFA, the payout percentage for an endowment fund is applied to the fund in its entirety, regardless of the original value of the restricted gift. Thus, the payout under UPMIFA is higher, provided that the trustees act with prudence. An example of how an endowment may spend funds under UMIFA and under this bill is attached as Exhibit 1.

Additionally, UPMIFA streamlines the process by which trustees of a charitable endowment may release restrictions imposed by donors on the expenditure of the endowment. Presently, under UMIFA, the release of a restriction on an endowment fund (a condition imposed by the donor that the fund may be used only for a stated charitable purpose) requires the charity to obtain court approval to release that restriction, with notice to the Attorney General.

In contrast, this bill will allow charities that have a restriction in a gift instrument to release that restriction without court approval, with the consent of the Attorney General, if the value of the fund is below \$250,000. Likewise, under this version of UPMIFA charities can release restrictions of funds having a value of less than \$50,000 with notice to the Attorney General.¹

Requiring a charitable organization to obtain court approval to release restrictions in all cases imposes significant legal expenses on the organization. We believe the provisions for consent by and

¹This bill slightly modifies the provisions of UPMIFA regarding the release of restrictions. UPMIFA allows a charity to release a restriction after 60 days notice to the Attorney General, provided that the fund has a value of \$25,000 or less.

notice to the Attorney General are sufficient to safeguard donor intent.

We have discovered a drafting error in this bill. Section 1 of the bill proposes a definition of the phrase "Activity and use limitations." This phrase is not located anywhere within the bill or the uniform law upon which this bill is based. Rather the term that should be defined is "Charitable purpose," which is used throughout the bill:

"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.

We respectfully request favorable consideration of this bill with the amendment described above.

Exhibit 1

The following example illustrates the concept of "historic dollar value" under UMIFA and UMIFA and how it affects a trustee's spending policy:

UMIFA

A donor gives \$100,000 in trust, specifying that the income is to be used for the benefit of a named charitable purpose:

- \$100,000 is the historic dollar value.
- There is a principal appreciation of \$10,000 over ten years.
- The fund now totals \$110,000.
- The fund also earns \$1,000 per year in ordinary income.

Over the past 36 months the principal has appreciated by 5%. The trustee therefore decides to adopt a 5% spending policy:

- $\$10,000 \times 5\% = \500
- Ordinary income = \$1,000
- Trustee may expend \$1,500 as "income" for the current year,

The 5% payout preserves the purchasing power of the principal while at the same time providing additional income for the charitable purpose.

UPMIFA

UPMIFA uses the "unitrust" model of endowment spending. In a unitrust model, the terms "principal" and "income" become obsolete. The payout percentage is applied to the fund *in its entirety*, regardless of the original value of the restricted gift.

\$110,000	Total value of fund principal
[\$100,000	Historic dollar value]
\$ 10,000	Appreciation/gain
\$ <u>1,000</u>	Annual ordinary income
\$111,000	Unitrust value of fund

Under UMIFA, the payout is calculated as follows: $\$111,000 \times 5\% = \$5,550$, whereas the payout under UMIFA would be \$1,500.

The net gain on payout under UPMIFA is therefore \$4,050.

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A SUMMARY

At its annual meeting in July 2006, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Prudent Management of Institutional Funds Act (UPMIFA) and recommended it for enactment by the legislatures of the various states. UPMIFA is designed to replace the existing Uniform Management of Institutional Funds Act (UMIFA), which was approved by NCCUSL in 1972 and has since been enacted in 47 states. UMIFA was a pioneering statute, providing uniform and fundamental rules for the investment of funds held by charitable institutions and the expenditure of funds donated as "endowments" to those institutions. Those rules supported two general principles: 1) that assets would be invested prudently in diversified investments that sought growth as well as income, and 2) that appreciation of assets could prudently be spent for the purposes of any endowment fund held by a charitable institution. These two principles have been the twin lodestars of asset management for endowments since UMIFA became the law of the land in nearly all U.S. jurisdictions.

UPMIFA continues these fundamental principles as a needed upgrade of UMIFA. Both investment in assets and expenditure for charitable purposes have grown exponentially in the 35 years since UMIFA was drafted; asset management theory and practice have also advanced. UPMIFA, as an up-date and successor to UMIFA, establishes an even sounder and more unified basis for charitable fund management than UMIFA has done.

INVESTMENT

In 1972, UMIFA represented a revolutionary advance over prevailing practices which imposed upon endowments the limited investment opportunities available for managing trust assets – even endowments not organized as trusts. By stating the first prudent investor rule in statutory law, UMIFA allowed endowments to invest in any kind of assets, to pool endowment funds for investment purposes, and to delegate investment management to other persons (e.g., professional investment advisors), as long as the governing board of the charitable institution exercised ordinary business care and prudence in making these decisions. A range of factors guided the exercise of prudence.

UPMIFA incorporates the experience gained in the last 35 years under UMIFA by providing even stronger guidance for investment management and enumerating a more exact set of rules for investing in a prudent manner. It requires investment "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." It requires prudence in incurring investment costs, authorizing "only costs that are appropriate and reasonable." Factors to be considered in investing are expanded to include, for example, the effects of inflation. UPMIFA emphasizes that investment decisions must be made in relation to the overall resources of the institution and its charitable purposes. No investment decision may be made in isolation, but must be made in light of the fund's entire portfolio, and as a part of an investment strategy "having risk and return objectives reasonably suited to the fund and to the institution." A charitable institution must diversify assets as an affirmative obligation unless "special circumstances" dictate otherwise. Assets must be reviewed within a reasonable time after they come into the possession of the institution in order to conform them to the investment



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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 investment decision-making, thus unifying both investment and expenditure decisions more concretely.

UPMIFA includes an optional provision that allows states to enact another kind of safeguard against excessive expenditure. If a state does not want to rely solely upon the rule of prudence provided in UPMIFA, the state may adopt a provision that creates a rebuttable presumption of imprudence if an institution expends an amount greater than seven percent of fair market value of a fund, calculated in an averaging formula over three years. While the seven percent rule is likely not to be necessary, it is available for those states that may be uncomfortable with the general standards.

RELEASE OR MODIFICATION OF RESTRICTIONS

UPMIFA recognizes and protects donor intent more broadly than UMIFA did, in part by providing a more comprehensive treatment of the modification of restrictions on charitable funds. Sometimes a restriction imposed by a donor becomes impracticable or wasteful or may impair the management of a fund. The donor may consent to release the restriction, if the donor is still alive and able to do so, but if the donor is not available the charity can ask for court approval of a modification of the restriction. The trust law doctrines of *cy pres* (modifying a



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purpose restriction) and deviation (modifying a management restriction) probably already apply to charitable funds held by nonprofit corporations. UPMIFA makes this clear. Under UMIFA, the only option with respect to a restriction was release of the restriction. UPMIFA instead authorizes a modification that a court determines to be in accordance with the donor's probable intention. If the charity asks for court approval of a modification, the charity must notify the state's chief charitable regulator and the regulator may participate in the proceeding.

UPMIFA adds a new provision that allows a charity to modify a restriction on a small (less than \$25,000) and old (over 20 years old) fund without going to court. If a restriction has become impracticable or wasteful, the charity may notify the state charitable regulator, wait 60 days, and then, unless the regulator objects, modify the restriction in a manner consistent with the charitable purposes expressed in any documents that were part of the original gift.

CONCLUSION

UPMIFA reflects and incorporates the 35 years of experience that has accumulated under the original UMIFA. Rather than changing institutional investment or expenditure practices, it brings them up to date and unifies them across a broad range of charitable funds. The better charitable institutions manage investments and prudently control expenditures, the more money they should have for program purposes.



**COMMENTS OF THE
COMMISSION TO PROMOTE UNIFORM LEGISLATION**

ON H.B. No. 618

**RELATING TO THE UNIFORM PRUDENT MANAGEMENT
OF INSTITUTIONAL FUNDS ACT.**

**BEFORE THE SENATE COMMITTEE ON JUDICIARY AND GOVERNMENT
OPERATIONS**

DATE: Thursday, April 2, 2009, at 10:15 a.m.
Conference Room 016, State Capitol

WRITTEN COMMENTS ONLY

(For further information, please contact Elizabeth Kent (352-2776) or Ken Takayama, (587-0655) Commissioners, Hawaii Commission to Promote Uniform Legislation)

E-MAIL to: JGOTestimony@Capitol.hawaii.gov

Chair Taniguchi and Members of the Senate Committee on Judiciary and Government Operations:

Hawaii's uniform law commissioners support the passage of House Bill No. 618. This is a version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) that includes some modifications suggested by charitable institutions in Hawaii.

This act, like its predecessor the Uniform Management of Institutional Funds Act of 1972, provides statutory guidelines for management, investment, and expenditures of endowment funds held by charitable institutions. The new act expressly provides for diversification of assets, pooling of assets, and total return investment, to implement whole portfolio management, bringing the law governing charitable institutions in line with modern investment and expenditure practice.

Laws substantially similar to this have been adopted by 26 states and the District of Columbia. Attached is a brief summary of UPMIFA for your information.

We note that this committee heard the Senate companion version of this measure, S.B. No. 121, on February 26, 2009.

We request some housekeeping amendments to this bill to conform to the final version of the Uniform Prudent Management of Institutional Funds Act. On page 1, line 10, of the bill, the term "Activity and use limitations" in section -2 of the new chapter should be changed to "charitable purpose".

On page 13 of the bill, in section -9 of the new chapter, the citations to the federal Electronic Signatures in Global and National Commerce Act should be changed by inserting "(c)" after "section 101" on line 3; by changing "(a)" to "(c)" in "section 7001(a)" on line 4; and by inserting "(b)" after "section 103" on line 5.

We urge your support of this bill and the requested housekeeping amendments.



March 30, 2009

Chair Brian Taniguchi
Senate Judiciary and Government Operations Committee
Hawaii State Senate
State Capitol, Room 016
Honolulu, HI 96813

RE: HB 618 SD 1, Relating to Uniform Prudent Management of Institutional Funds Act

Dear Chair Taniguchi and members of the Senate Judiciary and Government Operations Committee:

The Hawai'i Alliance of Nonprofit Organizations supports HB 618, SD 1, in particular, the move to allow charitable organizations to spend below the historic gift value of an endowment.

The current economic environment requires nonprofit organizations to be as resourceful as possible in identifying resources to sustain their good work in the community. HB 618 provides for this kind of latitude with regard to the treatment of nonprofit endowment revenue and offers appropriate guidelines for prudent use of these funds.

We are in support of public policy that provides flexibility to nonprofit organizations allowing them greater efficiency and capacity to meet their mission and deliver valuable services.

HANO unites and strengthens the nonprofit sector as a collective force to improve the quality of Hawai'i. It works in the areas of leadership and convenings, advocacy and public policy, research and information, communications, professional development, capacity building and products and services for its members.

Thank you for the opportunity to provide written testimony in support of this measure.

Lisa Maruyama
President and CEO



HAWAI'I COMMUNITY FOUNDATION

**TESTIMONY OF KATHARINE LLOYD
ON BEHALF OF HAWAI'I COMMUNITY FOUNDATION
TO THE SENATE COMMITTEE ON JUDICIARY AND
GOVERNMENT OPERATIONS**

**SUBJECT: TESTIMONY IN SUPPORT OF HB 618, SD1 – RELATING TO THE
UNIFORM PRUDENT MANAGEMENT OF INSTITUTIONAL FUNDS ACT**

Dear Chairman Taniguchi and members of the Committee on Judiciary and Government Operations,

On behalf of the Hawai'i Community Foundation, a 501(c)3 publicly supported charitable organization, I want to express and urge the critical importance to the Hawai'i non-profit community of HB 618 and strongly urge you to continue to move the passage of this bill.

The Hawai'i Community Foundation is organized to benefit the people of the State of Hawai'i and currently has more than 400 endowment funds dedicated for various charitable purpose. As a result of the economic downturn in the markets, a majority of the endowment funds we hold are below "historic gift value" and our grant making will be significantly impacted.

The new law will:

- Allow nonprofits to flexibility to spend endowment monies below historic gift value when is prudent under the circumstances.
- Provide guidance for nonprofits in their spending decisions, specifically that costs must be managed prudently in relationship to the assets.
- Provide new procedures for releasing restrictions on small funds that have been held for more than 20 years.

Hawai'i Community Foundation urges favorable action by this Committee and by the Senate.

Katharine P. Lloyd, General Counsel & Vice President of Operations