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## FISCAL IMPACT REPORT

**SPONSOR** Varela **ORIGINAL DATE** 2/08/09  
**LAST UPDATED** 2/27/09 **HB** 454/aHJC

**SHORT TITLE** Prudent Management of Investment Funds Act **SB** \_\_\_\_\_

**ANALYST** Hoffmann

### ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY09	FY10	FY11	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
<b>Total</b>		Unknown	Unknown	Unknown	Recurring	General Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

### SOURCES OF INFORMATION

LFC Files

#### Responses Received From

Attorney General's Office (AGO)  
Regulation and Licensing Department (RLD)  
Public Education Department (PED)

#### No Response

Administrative Office of the Courts

### SUMMARY

#### Synopsis of HJC Amendment

House Judiciary Committee amendment for House Bill 454 as amended by the House Judiciary Committee removes the reference to subsection D in Section 4. There is no subsection D in Section 4 of the bill, so the change is for clarity and consistency.

#### Synopsis of Original Bill

House Bill 454 would repeal the Uniform Management of Institutional Funds Act (UMIFA, currently found in Sections 46-9-1 through 46-9-12 NMSA 1978), promulgated in 1972 and enacted in 1997, and replace it with the Uniform Prudent Management of Institutional Funds Act (UPMIFA), promulgated in 2006 by the National Conference of Commissioners on Uniform State Laws (NCCUSL). The Bill has minor stylistic variations, and adds provisions to Section 2 excepting the Severance Tax Permanent Fund and the Permanent School Fund.

According to NCCUSL, UPMIFA makes the following changes from the UMIFA:

**Prudent Management and Investment.** UMIFA applied the 1972 prudence standard to investment decision making. In contrast, UPMIFA will give charities updated and more useful guidance by incorporating language from UPIA, modified to fit the special needs of charities. The revised Act spells out more of the factors a charity should consider in making investment decisions, thereby imposing a modern, well accepted, prudence standard based on UPIA.

Among the expressly enumerated prudence factors in UPMIFA is “the preservation of the endowment fund,” a standard not articulated in UMIFA.

In addition to identifying factors that a charity must consider in making management and investment decisions, UPMIFA requires a charity and those who manage and invest its funds to:

1. Give primary consideration to donor intent as expressed in a gift instrument,
2. Act in good faith, with the care an ordinarily prudent person would exercise,
3. Incur only reasonable costs in investing and managing charitable funds,
4. Make a reasonable effort to verify relevant facts,
5. Make decisions about each asset in the context of the portfolio of investments, as part of an overall investment strategy,
6. Diversify investments unless due to special circumstances, the purposes of the fund are better served without diversification,
7. Dispose of unsuitable assets, and
8. In general, develop an investment strategy appropriate for the fund and the charity.

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 continues 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.

**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. Amounts below historic dollar value cannot be spent. The Drafting Committee concluded that this endowment spending rule created numerous problems and that restructuring the rule would benefit charities, their donors, and the public. The problems include:

1. Historic dollar value fixes valuation at a moment in time, and that moment is arbitrary. If a donor provides for a gift in the donor's will, the date of valuation for the gift will likely be the donor's date of death (UMIFA left uncertain what the appropriate date for valuing a testamentary gift was.). The determination of historic dollar value can vary significantly depending upon when in the market cycle the donor dies. In addition, the fund may be below historic dollar value at the time the charity receives the gift if the value of the asset declines between the date of the donor's death and the date the asset is actually distributed to the charity from the estate.
2. After a fund has been in existence for a number of years, historic dollar value may become meaningless. Assuming reasonable long term investment success, the value of the typical fund will be well above historic dollar value, and historic dollar value will no longer represent the purchasing power of the original gift. Without better guidance on spending the increase in value of the fund, historic dollar value does not provide adequate protection for the fund. If a charity views the restriction on spending 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. UMIFA 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.

## **FISCAL IMPLICATIONS**

House Bill 454 makes no appropriations.

The AGO comments that the bill does include in Section 6 an unfunded mandate for the Attorney General to appear in court to speak to changes in the use of a gift proposed by a charity.

## **SIGNIFICANT ISSUES**

The AGO comments that in light of current economic difficulties relating to altered prudence standards employed by the investment industry, it is prudent to make a change at this time.

The AGO also questions whether the donor, or representative of the donor, should be heard with respect to a charity's efforts to modify a grant restriction. As presently proposed, Section 6(B),

(C) and (D) require only notice to the Attorney General when a charity seeks to modify a restriction in a gift. This conceivably would address a recent case where an Ivy League School was forced at the instance of the donor's family to return a sizable gift which it had been using in a manner inconsistent with restrictions in the gift. It also places the burden on the Attorney General to represent a donor's interest in modification disputes, something in which the Attorney General may have neither a stake, nor the expertise or adequate staffing to pursue.

### **TECHNICAL ISSUES**

The AGO observes that Section 4, page 6, refers, in the second line of Subsection A, to a Subsection D, which does not appear in Section 4.

### **OTHER SUBSTANTIVE ISSUES**

The AGO states that the National Conference of Commissioners on Uniform State Laws believes the prudence standards of the UMIFA, drafted in 1972, are outdated. UPMIFA adopts the approach of the Uniform Prudent Investor Act, §45-7-601 -- §45-7-612, NMSA 1978. It updates rules on investment making for trusts and charitable trusts, and makes them applicable to charities organized as nonprofit corporations. The intent is to make the investment standards for charities the same, regardless of the manner in which the entity was organized. UPIFA also changes how a charity might be released from restrictions imposed by the donor, or how those restrictions can be modified. It adopts the approach of the Uniform Trust Code, and imposes a duty on the Attorney General to review and be heard with respect to proposed modifications.

### **WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL**

The current statute would remain in place.

CH/mt