The Evolving Prudent Investor Standard and
UPMIFA's Rule of Construction for Spending "Income"

Prof. Susan N. Gary, University of Oregon School of Law

Development of the Prudent Investor Standard

- Although the prudent investor standard developed in trust law, it applies to any fiduciary
- The standard evolves as financial investing evolves, because the standard is based on other prudent investors and follows the norms of the finance industry. The standard has evolved from legal lists to conservative investments like bonds, to investments in the stock market, to investments like hedge funds and venture capital.

Early development

- 1830 – first articulation of the standard in Harvard v. Amory
- Cases in the nineteenth century said the trustee should avoid speculation; conservative investments were preferred to protect the principal
- Some states had legal lists, limiting investments to items on the lists
- Investments in the stock market were limited
- Restatement (Second) of Trusts (1959) – avoid speculative investments, consider each investment for risk, stick to conservative investments

Mid-twentieth century

- Development of modern portfolio theory led to new ways of thinking about prudent investing: analyze risk across the portfolio, rather than asset by asset
- Total return investing became important

Uniform Prudent Investor Act (1992) (UPIA)

- Applies to trusts
- Adopted the ideas of modern portfolio theory
- A fiduciary must act as a prudent investor, considering factors related to general economic conditions and the specific needs of the trust.
- Consider all of the following factors that are relevant:

    - Intent of the donor expressed in a gift instrument
    - General economic conditions
    - Possible effect of inflation or deflation
    - Expected tax consequences
    - Role of each investment in overall portfolio
    - Expected total return
    - Other resources of the institution
    - Needs of institution to make distributions and preserve capital
    - Asset's special relationship to institution's purposes

Principal and Income

- Statutes provide guidance for determining principal and income for trusts
- Trust accounting income is not the same as taxable income
- Income included interest, dividends, and rents
- Principal included contributions and capital gains
- Uniform Fiduciary Principal and Income Act (2018) – power to adjust between income and principal

Uniform Management of Institutional Funds Act (UMIFA) (1972)

- Many charities, especially large ones with endowments, are organized as nonprofit corporations. In the 1960s there was concern that trust rules applied to these big endowments, and that the endowments must be invested in a conservative manner. In addition, if trust rules applied to the way income is determined, then income does not include capital gains. As a consequence, large university endowments were invested in bonds, rather than the stock market, and over time they were losing value.
- Cary & Bright, The Law and Lore of Endowment Funds (1969), led to the development of UMIFA. UMIFA applied to charities organized as nonprofit corporations (and not to charitable trusts).
- Applied prudent investor rule to nonprofit corporations
- Created a rule of construction for spending from endowment funds

Problem: If "income" is defined as trust accounting income, then income means interest and dividends and does not include capital gains. Investment decision making may be focused on generating income, rather than on creating value for the portfolio. To be a prudent investor the fiduciary should be engaged in total return investing.

Solution: Create a rule of construction that says that "income" will mean the amount the Board of Directors determines to be prudent, above historic dollar value (HDV). HDV was defined to mean the amount originally contributed to the endowment. The solution encourages total return investing.

Uniform Prudent Management of Institutional Funds Act (UPMIFA)

- Updates the prudent investor rule, adopting the UPIA provisions
- Modifies the rule of construction for spending income

Problem: HDV might be too low, for an old fund, or too high, for a fund created shortly before a drop in market value. Better guidance would improve spending decisions.

Solution: Change the rule of construction to say that the Board of Directors can make distributions that are prudent, after considering factors spelled out in the statute.

UMIFA and now UPMIFA provide guidance as to the meaning of income when a fund directs the fiduciary to "spend only the income."

UPMIFA directs the charity to spend from an endowment fund the amount determined to be "prudent for the uses, benefits, purposes, and duration for which the endowment fund is established." The decision-maker must consider the following factors, if relevant:

- Duration and preservation of the fund
- Purposes of the institution and the fund
- General economic conditions
- Possible effect of inflation or deflation
- Expected total return
- Other resources of the institution
- Investment policy of the institution