Newsletter

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Lessons for Charities from the Laws of Prudent Investing[1]

In 2001, Michael Mooney, president of Lewis & Clark College, lent $10.5 million of his school's money to a struggling oil-processing company. The borrower soon defaulted and then went bankrupt, Mooney resigned from his post, and the college may have lost an amount equal to 10 percent of its operating budget for the year. *See* Steven Carter, "Violations of Policies are Costly to College," The Oregonian, June 5, 2003, at 1; Todd Murphy, "Could College Have Halted Bad Loan?," Portland Tribune, June 10, 2003, at 1; Todd Murphy, "Audit Pointed to College's Risky Loan," Portland Tribune, July 1, 2003, at 1; Mark Zusman & Nigel Jaquiss, "The Money Trail," Willamette Week, June 4, 2003, at 7.

In the 1990s, hundreds of investors, including several universities and the American Red Cross, were duped into investing in a Ponzi scheme known as The Foundation of New Era Philanthropy ("New Era"). New Era promised a 100 percent return in six months. However, New Era collapsed and its investors collectively lost $500 million. *See* Charles Fox & Benetta Park, "How Fiduciaries Can Avoid Another New Era Philanthropy Debacle," 136 Tr & Est 26 (May 1997).

The loss of a charity's investment is a double tragedy: donors' money is squandered, and good works are jeopardized. Complying with the laws of prudent investing can help charities avoid mistakes like those made by President Mooney and the New Era investors. The chief sources of law are the Uniform Management of Institutional Funds Act ("UMIFA"), the Uniform Prudent Investor Act ("UPIA"), and the federal excise taxes on "jeopardizing investments." This article reviews those laws and then suggests some practical ideas for compliance.

Uniform Management of Institutional Funds Act

Oregon's version of UMIFA was adopted in 1975 and is codified at ORS 128.310 to 128.355. It applies generally to colleges, universities, hospitals, religious organizations and other eleemosynary institutions, including most private foundations. However, it does not apply to funds with individual beneficiaries, such as charitable remainder trusts, or funds held in trust for a charity by a corporate trustee. ORS 128.315(1) – (2).

UMIFA was inspired by a 1969 study of school endowment funds. William L. Cary & Craig B. Bright, *The Law and the Lore of Endowment Funds* (1969). The study, sponsored by the Ford Foundation, found that endowment managers were hamstrung by their fears of liability for investing in stocks, investing on a total-return basis (particularly, making distributions for current needs out of capital gains), and delegating investment decisions to third parties. As a result, the endowments overemphasized bonds, reducing their long-term growth and ability to beat inflation.

UMIFA responded to each of the study's concerns. It authorizes a charity's board

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to spend, for current needs, a prudent amount of appreciation, realized and unrealized, in the charity's endowment fund. ORS 128.320. Thus the charity can increase the equity portion of its portfolio while still meeting current operating expenses.

UMIFA abolishes categorical restrictions on the types of property in which a charity may invest. ORS 128.330. It also authorizes a charity's board to delegate investment decision-making to a board committee, employees, or outside investment advisors. ORS 128.335.

The heart of UMIFA is its investment standard, stated in ORS 128.340:

> "In the administration of the powers to appropriate appreciation, to make and retain investments and to delegate investment management of institutional funds, members of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. In so doing they shall consider long and short term needs of the institution in carrying out its education, religious, charitable or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends and general economic conditions."

This investment standard has important implications. Investment decisions are not to be judged in hindsight. The standard of care is more comparable to that of a director of a business corporation than to that of a private trustee. The board should invest on a total-portfolio basis, rather than focusing solely on avoiding risk of loss for each investment and thereby stunting long-term growth. The focus on total return implies the need to diversify investments. At the same time, the overall portfolio must be prudently managed.

The terms of a donor's gift instrument can narrow the range of investments otherwise permitted by UMIFA. ORS 128.325, 128.330. However, a charity may obtain a release of gift restrictions with the consent of the donor or, in some cases, with court approval. ORS 128.345.

Uniform Prudent Investor Act

UPIA is the UMIFA's younger cousin. UPIA was adopted in Oregon in 1995 and is codified at ORS 128.192 to 128.218. It applies to trusts administered by trustees for income beneficiaries, remainder beneficiaries, or both. ORS 128.005(1), 128.192. These include charitable lead and remainder trusts. The UPIA does not apply to funds administered by charities for their own account.

UPIA is more detailed than UMIFA. However, many features of the two acts are similar. UPIA contains default rules that can be expanded or limited by the trust document. ORS 128.194, 128.196(1). No investments are categorically prohibited, so long as they are prudent. ORS 128.196(5). The trustee must diversify investments unless special circumstances require otherwise. ORS 128.198. Compliance with the prudent-investor rule is not determined in hindsight, but on facts known at the time of the trustee's investment decision. ORS 128.208.

A trustee's investment decisions for individual assets are evaluated not in isolation but in the context of the trust portfolio as a whole, and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust. ORS 128.196(2). The trustee must consider the trade-off between risk and return. *Id*. Stocks promise the greatest long-term return but have the greatest short-term volatility. Preservation of capital is no longer the sole measure of trust investing. A trustee should consider other factors, including general economic conditions, the possibility of inflation or deflation, the expected total return of income plus capital appreciation, and the need for liquidity, regular income, and capital appreciation. ORS 128.196(3).

UPIA authorizes trustees to delegate investment decisions. ORS 128.212(1). Further, a trustee may be liable for failure to delegate when it selects investments, such as real estate or venture capital, that require special skills the trustee lacks. Restatement (Third) of Trusts §§ 171 cmt a, 227 cmt j (1992). The trustee is not liable for investment losses if it acts prudently in selecting, monitoring, and setting guidelines for the outside investment manager. ORS 128.212(3).

Federal Excise Taxes on Jeopardizing Investments

Section 4944 of the Internal Revenue Code creates a parallel universe of investment rules for private foundations. *See generally* Bruce R. Hopkins & Jody Blazek, *Private Foundations: Tax Law and Compliance* ch 8 (2d ed 2003); Donald P. DiCarlo, Jr., "The Section 4944 Tax on Jeopardizing Investments: 'Double Jeopardy''for Foundation Managers?," 16 No. 4 Prac Tax Lawyer 33 (2002). Investments that jeopardize the carrying out of the foundation's exempt purposes can trigger an excise tax of 5 percent annually on the amount so invested. IRC § 4944(a)(1).

A similar tax applies personally to foundation managers who participate in investments while knowing they are jeopardizing the foundation's ability to carry out its exempt purposes. *Id*. § 4944(a)(2). Foundations and managers face additional taxes if they do not promptly remove the jeopardizing investment after the initial tax is imposed. *Id*. § 4944(b).

Treasury Regulation § 53.4944-1(a)(2)(i) defines jeopardizing investments. The definition is similar to the prudent-investment standards of UMIFA and UPIA, although compliance with state law does not automatically satisfy the regulation. Foundation managers should consider a range of factors, including income, capital appreciation, risks, and the need for diversification. *See* Treas Reg § 53.4944-1(c). No investment is categorically prohibited. Certain investments, including margin trading, commodity futures, oil and gas interests, options, and short selling, are singled out for special scrutiny. However, the Internal Revenue Service has issued favorable letter rulings for high-risk investments that seemed prudent in the context of the foundation's overall circumstances. E.g., Tech Adv Mem 8718006 (Feb. 2, 1987) (purchase of gold stocks as inflation hedge); Priv Ltr Rul 9237035 (June 16, 1992) (commodity trading); Tech Adv Mem 200218038 (Apr. 23, 2001) (fund investing in futures and forward contracts).

The jeopardizing-investment rules do not apply to investments received by foundations as donations, Treas Reg § 53.4944-1(a)(2)(ii)(a), or to program-related investments, IRC § 4944(c); Treas Reg § 53.4944-3. "Program-related" investments are those made to carry out the charity's purposes, and not to produce income or capital appreciation or to further legislative or political agendas. Treas Reg § 53.4944-3(a); *see also* IRC § 170(c)(2)(D). Examples include community-development investments or loans by foundations working to improve blighted neighborhoods. *See* Treas Reg § 53.4944-3(b).

Foundation managers can avoid personal liability for jeopardizing investments if they obtain and rely on reasoned written opinions of legal counsel stating that the proposed investments are not jeopardizing as a matter of law (for example, as program-related investments). Similarly, managers can protect themselves if they obtain and rely on advice from qualified investment counsel stating that the proposed investments will provide for the foundation's long- and short-term financial needs. Note, however, that professional advice counts only if it is based on the facts, fully disclosed to the lawyer or investment counsel. Treas Reg § 53.4944-1(b)(2)(v).

Other Rules That Apply to Charitable Investments

This article does not attempt to cover excise taxes on self-dealing, unrelated-business taxable income, and excess business holdings. For a good summary of these taxes and how to avoid them, see Alan Halperin & Rachel Harris, "Investment Guidelines for Private Foundation Managers," 30 Est Planning 542 (2003).

Some Practical Suggestions

A charity's challenge is to harmonize its freedom from arbitrary investment shackles with its continuing, fundamental duty to invest prudently. Here are 10 practical suggestions to offer to clients that are charities:

- Objectively analyze short-term and long-term investment needs and tolerance for risk. The right approach is very different for endowments than for short-term operating reserves or for charitable remainder trusts with required annual payments to income beneficiaries. For a helpful discussion of the analysis involved, along with forms, *see* Robert Fry, *Nonprofit Investment Policies* 91-121 (1998).
- Obtain suitable investment advice, taking into account the advisor's cost, expertise, and objectivity. The range of choices includes mutual funds, banks, stockbrokers, registered investment advisors, and consultants who screen other advisors. Few lawyers are qualified to be investment advisors, but lawyers can help clients ask the right questions. For tips on how to choose among investment managers, *see* Fry, *supra*, at 122-151.
- Although categorical investment restrictions are abolished, do not follow an "anything goes" strategy. Simple, conservative investments are still often the best. As Warren Buffet, perhaps this country's greatest living investor, has stated: "Investors should remember that their scorecard is not computed using Olympic-diving methods. Degree of difficulty doesn't count." Warren Buffett, "Chairman's Letter to Shareholders," Berkshire Hathaway, Inc. Annual Report 16 (1994).
- Beware of investment fads. Yesterday's fad was the Internet bubble. Today's involves hedge funds—essentially, investment pools that have higher fees than and are less regulated, less liquid, more exclusive, and more leveraged than mutual funds. Some hedge funds have fine records and deserve consideration. However, on average, hedge funds have not done as well as broad

market indexes over long periods. The higher fees can hurt performance. *See* Neil Weinberg & Bernard Condon, "The Sleaziest Show on Earth," Forbes, May 24, 2004, at 110. Perhaps because of the risks of leverage, the odds that a hedge fund or hedge fund manager will survive for seven years are less than 20 percent. Sigma Investment Company Newsletter at 1 (May 2002); *see generally* Patrick Collins, "Hedge Funds: A Critical Examination," 28 ACTEC J 36 (2002). A few years ago, the Long-Term Capital Management LP fund, guided by two Nobel laureates in economics, lost nearly $2 billion—44 percent of its capital—when unexpected market tremors occurred. Ultimately, the fund was rescued only by a $3.5 billion bank bailout. *See* Peter Truell, "Fallen Star: The Managers—An Alchemist Who Turned Gold into Lead, The New York Times, Sept. 25, 1998, at C1; Peter Coy & Suzanne Wooley, "Failed Wizards of Wall Street," Business Week, Sept. 21, 1998, at 114.

- If it sounds too good to be true, it probably is. The New Era investors should have been suspicious of a promise of a 100 percent return in six months.
- Do not make investments without obtaining adequate and plausible financial disclosures. This was another warning sign with the New Era fund. *See* Fox & Park, *supra*.
- Establish investment guidelines and procedures and then have the discipline to stick to them. This discipline is essential in avoiding the temptation to stray, out of panic or euphoria, as markets blow hot or cold. President Mooney's $10.5 million loan violated at least three rules previously adopted by the Lewis & Clark College board to limit investment risk. Steven Carter, "Violations of Policy are Costly to College," The Oregonian, June 5, 2003, at A12.
- Stocks beat bonds in the long run, but in the short run that may not be true, and the short run can be painfully long. *See* Jonathan A. Levy, "The Total Return Unitrust: Is It Time for High-Fives?," 139 Tr & Est 49 (June 2000). During the post-Vietnam era of inflation, between 1967 and 1980 or so, Treasury bonds outpaced the stock market. The recent stock market downturn was another reminder of the risks of stocks. Most charities should continue to hold some bonds in their portfolios.
- Look a gift horse in the mouth. Polluted real estate, hard-to-sell collections of wine or antiques, and charitable trusts or gift annuities that cost more to administer than they earn are examples of gifts that a charity is better off without.
- Charitable boards and investment committees should maintain records showing that they intelligently considered their investments. Prudent investments are not judged in hindsight, but boards and trustees risk liability for bad results if it appears that they were asleep at the wheel. *See*, *e.g.*, *In re Estate of Janes*, 90 NY2d 41, 681 NE2d 332, 659 NYS2d 165 (1997) (noncharitable trust).

Conclusion

Charitable investing is a special area in which financial acumen and idealism combine to improve the world. Lawyers can play an important role in this mix by helping charitable clients comply with the prudent-investment laws.

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Footnote:

1. Some parts of this article were taken from a previous article by the author, "Uniform Prudent Investor Act in Oregon," Or Est Plan & Admin See Newsl, (Jan. 1999).

Revising UMIFA

NOTE: *Jonathan Levy's article in this issue explains the importance of current UMIFA for Oregon charities.*

Background

The Uniform Management of Institutional Funds Act ("UMIFA") was originally promulgated in 1972 and was adopted in Oregon in 1975. UMIFA provides guidance on investment authority, permits delegation of authority to independent financial advisors, authorizes the expenditure of appreciation of investment funds, and provides rules for the release of restrictions on the use or investment of funds. UMIFA applies to charities organized as nonprofit corporations and unincorporated associations but does not apply to charitable trusts.

As a Uniform Act, UMIFA has been highly successful. Forty-seven jurisdictions have enacted UMIFA, and although variations exist among those enactments, the general principles of UMIFA have been adopted almost universally. UMIFA's approach to endowment management—permitting the expenditure of unrealized appreciation—has enabled fund managers to use modern investment techniques such as total-return investing and unitrust-style spending. UMIFA was, in a sense, a forerunner of the Uniform Prudent Investor Act ("UPIA"), an act that regulates the investment responsibilities and authority of trustees.

Although UMIFA has been successful, a Study Committee appointed by the National Conference of Commissioners on Uniform State Laws ("NCCUSL") determined that the time had come for a revision. The Drafting Committee began its work on a new version of UMIFA ("Revised UMIFA") in 2002. The Drafting Committee expects to ask for approval of Revised UMIFA at the July 2005 annual meeting of NCCUSL. It will then be ready for consideration by legislatures.

What Charities Will Revised UMIFA Cover?

One change is that Revised UMIFA will apply to all charities, regardless of the form of organization. Although UMIFA does not apply to trusts, much of Revised UMIFA already applies to charitable trusts, in states that have adopted UPIA and the Uniform Principal and Income Act. In Revised UMIFA, only the endowment spending rules and two of the *cy pres* rules are different from existing uniform laws applicable to trusts. The Drafting Committee concluded that as a policy matter the rules for the management, investment, and expenditure of charitable funds should not depend on the organizational form of the charity.

Revised UMIFA will also apply to funds held by a corporate trustee for the exclusive benefit of a charity. UMIFA currently excludes those funds.

What Funds Will Revised UMIFA Cover?

As under current UMIFA, Revised UMIFA will cover all funds held and managed by a charity for its charitable purposes. Most sections of UMIFA apply to all funds held by a charity, but the rules on endowment spending apply only to funds that meet the definition of an endowment fund under UMIFA.

For purposes of UMIFA, an endowment fund is a fund that is not wholly expendable on a current basis. The intent of the charity and the donor as expressed in the terms of the gift instrument used to create the fund determine whether a fund is an endowment fund and determine the fund's duration. Most endowment funds have an indefinite duration, but a fund created with the intention that the assets be exhausted within a 10-year period is treated as an endowment fund under UMIFA.

What Will Revised UMIFA Not Cover?

The Drafting Committee excluded assets held primarily for program-related purposes from the scope of Revised UMIFA. Revised UMIFA still provides that if an asset held for investment purposes also has a program-related purpose, the decision makers can consider that program-related purpose in making an investment decision.

UMIFA is not a comprehensive statute addressing all legal issues that apply to charitable organizations. UMIFA governs the investment and management of charitable funds, the spending of endowment funds, and the modification of restrictions on charitable funds. Those who govern charities will continue to look to other laws for guidance on other governance issues. Charities organized as nonprofit corporations are governed by the laws applicable to nonprofit corporations, including any nonprofit corporation statutes, and charities organized as charitable trusts are governed by trust law, both the common law and any statutory law.

Standard for Investing and Managing Institutional Funds

Section 3 of Revised UMIFA adopts the prudence standard for managing and investing funds held by charities. Directors, trustees, and others responsible for managing charitable funds must invest the funds as a prudent investor would. Revised UMIFA sets forth factors the institution should consider in making investment decisions. Some factors focus on the nature of the charity and the particular fund. These factors include directions from the donor in the gift instrument, the purposes of the charity and of the fund, the institution's needs to make distributions and preserve capital, and other resources of the institution. Other factors look to general economic conditions and investment strategies that analyze the portfolio as a whole, including total-return investing and sensitivity to the risk-and-return curve of the entire portfolio.

The language used in Revised UMIFA's articulation of the prudence standard is derived from section 8.30 of the Revised Model Nonprofit Corporation Act. The standard is consistent with the business judgment standard under corporate law, but as applied to charitable institutions instead of businesses. The charitable nature of the institution affects the decision making of a prudent person acting under the UMIFA standard. For that reason, the Drafting Committee concluded that the prudence standard is—and should be—the same regardless of whether a charity is organized as a nonprofit corporation or as a trust. The slight differences in language between the articulation of prudence in UPIA and in the Revised Model Nonprofit Corporation Act do not reflect a difference in the way managers of charities should exercise prudence.

Expenditures from Endowment Funds

Historic Dollar Value. One of the reasons behind UMIFA was a need to permit investment strategies that did not depend on the characterization of an institution's assets as income or principal for accounting purposes. If an institution could spend only "income" from an endowment fund, then investments in assets with appreciation potential could affect the institution's ability to use its endowment. UMIFA created the concept of "historic dollar value" and then permitted the expenditure of appreciation in excess of historic dollar value if the institution determined that expenditure of the funds was prudent. Historic dollar value is determined based on contributions to the endowment fund. Income, appreciation, and depreciation of assets do not affect historic dollar value.

Historic dollar value reflects neither the passage of time nor the fund's investment results. For some organizations, historic dollar value has little meaning. An institution established in 1930 would have an historic dollar value substantially below the value of the initial gift if the gift amount were adjusted to reflect inflation.

For other organizations, the recent drop in the stock market means that endowment funds established at the end of the 1990s may have historic dollar values significantly higher than their current values. A rule that permits distributions only if the asset value of an endowment fund exceeds the value at the time a donor made contributions could prevent the charity from distributing anything for many years.

Charitable advisors have opined that managers of an endowment fund governed by UMIFA can continue to spend ordinary income, even when the fund's value is below its historic dollar value. Some underwater funds may choose to return to the pre-UMIFA world, investing for income rather than using total-return strategies. Of course, such an approach will slow the fund's growth, so that regaining historic dollar value will be even more difficult.

New Approach. Revised UMIFA will provide more flexibility to the persons at the institution who make decisions about expending funds. The intent is not to allow a governing board to convert an endowment fund into a nonendowment fund, but rather to encourage the board to preserve the purchasing power of the current value of an endowment fund. The institution should be able to establish a spending approach that will be responsive to short-term fluctuations in the value of the fund.

In Revised UMIFA, the Drafting Committee replaced the historic dollar value approach with a standard of prudence that applies to the decision-making process of the governing board. Acting prudently and in good faith, the decision makers must consider a number of factors in deciding how much to distribute from an endowment fund. These factors include the institution's purposes and needs, the intent of donors to the endowment fund, the availability of other resources, and general economic conditions.

Donor-Imposed Restriction Limiting Expenditures. In making decisions to expend endowment funds, a charity must honor a donor's intent. Any documents relied on by the charity and the donor in setting the terms of the gift will guide the charity as it makes decisions concerning the endowment.

UMIFA provides rules of construction to assist institutions in interpreting donors' intent. If a donor directs a charity to spend "only the income" from a fund or to treat a fund as an "endowment," the donor is unlikely to be concerned about designation of investment returns as "income" or "principal" under accounting principles. Instead, the donor likely assumes that the institution will use modern investing strategies such as total-return investing to generate enough funds to make ongoing distributions while maintaining the long-term viability of the fund. The rules of construction in UMIFA assume that instructions by the donor to the charity to use "only the income" from a fund mean that the donor intends that the fund both support current expenditures and be preserved indefinitely.

A donor may restrict the charity's ability to expend funds under the UMIFA standard, but the donor must state the restriction specifically. For example, a donor might choose to require that a charity spend between 3 and 5 percent of the assets held in an endowment each year, regardless of investment performance or other factors. If the charity agrees to the restriction in accepting the gift, the restriction will govern spending decisions by the charity.

If a donor wants to limit expenditures from an endowment gift to accounting income and does not want the institution to be able to expend appreciation under Section 4 of UMIFA, then the donor must say so explicitly in the gift instrument. An instruction to "pay only the income" will not be specific enough, but an instruction to "pay only interest and dividend income earned by the fund and not to make other distributions of the kind authorized by Section 4 of UMIFA" should be sufficient.

Spending Guidelines. The members of the Drafting Committee are comfortable with relying on prudence as the appropriate approach for endowment spending and do not anticipate that the change will lead to unrestrained spending of endowments. The Drafting Committee believes that charities will continue to develop sensible spending rules under Revised UMIFA, as they have under current UMIFA, and that those spending formulas will continue to evolve as market conditions and charitable needs change.

A few observers have expressed concern about the lack of a statutory ceiling or floor for spending. The concern is that without a bright-line spending rule, charities may be tempted to spend more than is prudent or may have difficulty determining a prudent spending pattern and may not spend enough. Attorneys general may find regulating charities more difficult without an easy-to-determine standard.

The Drafting Committee considered creating a rebuttable presumption of prudence if a charity spends between 3 and 5 percent (or between 2 and 7 percent) of the asset value of the endowment fund, determined over a three-year period. The Drafting Committee rejected this sort of a spending rule because any fixed range would soon be out of date and could not take into consideration the range of factors listed in Revised UMIFA. Further, the use of a presumption of prudence could encourage spending at levels higher than would be prudent in some years.

An alternative approach would be to include a rebuttable presumption of imprudence if spending exceeds 7 percent of the funds value of a fund computed over a rolling three-year period. The presumption of imprudence raises concerns similar to those raised by the presumption of prudence for spending within a specified range.

Although the current draft of Revised UMIFA does not include either of these rebuttable presumptions, both are still under consideration. The Drafting Committee seeks input on the usefulness of including a fixed spending guideline in the Uniform Act.

Delegation of Investment Management

UMIFA contains a provision permitting delegation of investment authority, so the power to delegate investment management is not new. Revised UMIFA will update the delegation provision by incorporating UPIA's language on delegation. UMIFA applies only to external delegation. Other laws will continue to govern internal delegation, for example, delegation by a board of directors to officers or employees of a nonprofit corporation.

Release or Modification of Restrictions

UMIFA adopted a modification provision that applied something akin to *cy pres* to charities organized as nonprofit corporations. The Drafting Committee wanted to clarify the somewhat confusing language of UMIFA and provide an easier method for a charity to modify restrictions on a fund with a small value that had existed for a long time and whose purposes were no longer in synch with those of the charity.

With Donor Consent. A donor can consent, in writing, to release a restriction on the use or investment of an institutional fund. Under UMIFA, the power to release a restriction does not create a power with tax consequences for the donor. The initial gift will be a completed gift because the power to release the restriction does not include a power to divert the property from the charitable beneficiary.

Cy pres. Revised UMIFA adopts the *cy pres* approach provided for charitable trusts in section 413 of the Uniform Trust Code. The governing board must seek court approval for the change and must give notice to the state attorney general. The court may release or modify the restriction if the restriction is "unlawful, impracticable, impossible to achieve, or wasteful." Any release or modification must be consistent with the purposes of the fund as expressed in the gift instrument. As under *cy pres*, Revised UMIFA does not require the charity to notify donors to a fund that is subject to cy pres of a proposed release or modification. However, good practice is to notify all donors who can reasonably be located.

Small Value, Old Fund. If a fund has a total value of less than $25,000 and has existed for at least 20 years, the governing board can apply *cy pres* itself, without court approval, if the other requirements of *cy pres* are met. The charity must notify the state attorney general of the proposed modification and must use the fund in a manner consistent with the purposes stated in the gift instrument.

The Drafting Committee determined that for some small funds that have existed for a long time, a restriction may no longer make sense but the cost of a judicial *cy pres* proceeding would be prohibitive. The fund may have many donors, or, because of the fund's age, the donor may be deceased or impossible to find. Either way, obtaining donor consent may not be feasible, so judicial *cy pres* may be the charity's only option. The Drafting Committee wanted to allow a charity to modify the restriction without the cost of going to court.

Input for the Drafting Committee. The Drafting Committee continues to solicit input from anyone with an interest in Revised UMIFA. Comments should be sent to the reporter, Susan Gary, by email (if possible) to *sgary@law.uoregon.edu*, or by regular mail to Professor Susan N. Gary, University of Oregon School of Law, Eugene, OR 97403-1221. An electronic copy of the current draft of Revised UMIFA can be obtained by requesting it from Susan Gary or by looking online. Go to *www.nccusl.org*, click on NCCUSL Committees, click on Drafting Committees, and select Management of Institutional Funds. The current draft, dated August 25, 2004, and a memorandum outlining issues to be discussed at the Drafting Committee's December meeting are posted.

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Caba v. Barker: A New Duty for Will Drafters or Just Business as Usual?

An Oregon appellate court decision, *Caba v. Barker*, 193 Or App 768, 93 P3d 74 (2004), decided in June, has potentially difficult ramifications for Oregon lawyers drafting wills. Although the facts in the case are troubling, and therefore the result is not surprising, the arguments advanced by the plaintiffs and the scope of the court's decision could have effects far beyond those of the particular facts in the case.

Background

Those facts are fairly straightforward. In *Caba*, a testator who had recently suffered a stroke created an estate plan that left residuary gifts to the plaintiffs, one of whom was a relative by marriage and the other of whom was a blood relative. Charles Carnese, an attorney who was related to the testator by marriage and had previously represented her on other matters, was aware of the testator's estate plan and was also named as a beneficiary. Carnese arranged for the defendant Barker, a friend and former colleague, to visit the testator in the hospital and prepare her will. Barker knew or should have known the testator's will included gifts to Carnese. Barker promised to prepare the testator's will, and, according to the plaintiffs' third amended complaint, made "an implied promise to make the will invulnerable to a will contest." The will gave Carnese a gift of $35,000, named him as a residual beneficiary, and appointed him personal representative of the testator's estate. The testator died a few weeks after executing the will.

Inevitably, shortly after the will was admitted to probate, a will contest was filed, the settlement of which resulted in a cost to the estate of approximately $620,000, reducing each beneficiary's bequest by more than $100,000. Also inevitably, less than two years after the testator's death the plaintiffs filed an action against Barker alleging claims for breach of contract and negligence. The plaintiffs alleged that they were intended donee beneficiaries of Barker's promises, which included "his promise to prepare a will which would not be attacked by a will contest." The plaintiffs also alleged that Barker was unable to provide independent legal services to the testator for several reasons, including his relationship with Carnese and Barker's failure to sufficiently communicate with the testator or properly consider her physical condition. Specifically, the complaint pleaded 12 particular instances of negligence:

- Barker failed to advise the testator that her estate plan could foreseeably give rise to a will contest;
- He did not ascertain from the testator her reasons for the estate plan so that he would be able to testify about it in the event of a will contest;
- He did not advise the testator that, because he was Carnese's colleague and friend, his independence would be an issue in the will contest;
- He failed to advise the testator to obtain the services of an independent lawyer;
- He failed to act independently of Carnese by personally interviewing the testator before the will was prepared, by advising her without Carnese's assistance, and by obtaining a second witness to the will who had not been obtained by Carnese and who was not an unwilling witness;

- He relied upon Carnese for information about the testator's estate plan before even meeting with the testator and used as the will a form that Carnese had prepared;
- He failed to investigate the testator's physical, mental, and emotional status at the time of execution, including her vision and how to successfully communicate with her;
- He failed to include reasons in the will for disproportionately favoring the relatives by marriage (including Carnese) and disfavoring blood relatives;
- He failed to ascertain the family situation between blood relatives and relatives by marriage existing at the time the will was executed;
- He failed to ascertain the animosity between Carnese and the hospital staff;
- He failed to recognize that the circumstances surrounding the testator's estate plan included factors that a reasonable lawyer would have recognized exposed her estate plan to a will contest (these factors included the issue of Barker's independence, his failure to inform the testator of these factors, and his failure to minimize the factors so as not to create an unreasonable risk of will contest, *including* the failure to video- or audio-tape the interview); and
- He failed to otherwise minimize the chances of a will contest being filed or the success of a will contest.

The defendant moved to dismiss both the breach of contract and the negligence claims. Barker argued that under *Hale v. Groce*, 304 Or 281, 744 P2d 1289 (1987), only the client could recover damages for breach of contract or negligence in the absence of a "specific promise" to benefit a nonclient third party. Barker also argued that the plaintiffs' pleadings were legally insufficient because they alleged merely an implied promise to make the testator's will invulnerable to a will contest. The trial court agreed with him.

Appellate Court Decision

On appeal, the Oregon Court of Appeals identified two "overarching" questions. First, did the plaintiffs sufficiently allege that they were intended beneficiaries of Barker's performance, to permit them to pursue an action against him? Second, did the plaintiffs sufficiently plead claims for negligence, breach of contract, or both? The court began its analysis of the first question by reviewing, in some detail, the holdings in *Hale* and decisions from other jurisdictions. The court also looked at *Lord v. Parisi*, 172 Or App 271, 19 P3d 358, rev den, 332 Or 250 (2001), to "corroborate" the understanding in *Hale*. The court held that nothing in *Hale* or any subsequent case "requires that the attorney make a *specific*, as opposed to a general, promise to the client." (Emphasis in original.) Rather, the important question is whether the nonclient was, in fact, a donee beneficiary of the attorney's promised performance. The court must assess the intent of the attorney and the client with respect to the rendering of professional services and, particularly, to determine whether 'in view of the accompanying circumstances,' the client's intent in obtaining the attorney's services was to give the beneficiary 'the benefit of the [attorney's] promised performance.'" (Citations omitted; brackets in original.) Applying this standard, the court found that the plaintiffs in this case, like those in *Hale*, were classic intended third-party beneficiaries of Barker's promised performance in drafting the testator's will. The plaintiffs' pleadings sufficiently alleged a source of duty outside the common law of negligence, permitting them to prosecute an action against Barker.

The court next looked at whether the plaintiffs' complaint sufficiently pled claims in tort, contract, or both. First, the court noted that the plaintiffs' complaint alleged that Barker agreed to "render professional services, the preparation of [the testator's] will, and that, in the course of that representation, defendant was negligent in various particulars, causing plaintiffs, as donee beneficiaries, to suffer damages." Therefore, as in *Hale*, those allegations adequately alleged a claim that the defendant was to use his professional skill to accomplish the testator's objectives, but failed to do so, which, under *Hale*, is a tort claim. Second, the plaintiffs' contract claim is predicated upon the defendant's breach of an alleged promise to make the will "invulnerable to a will contest." (Emphasis added.) This implied promise committed the defendant to "'performance without reference to and irrespective of any general standard.'" (Citations omitted.) The court noted that the scope and content of the alleged promise is ambiguous: a broad reading could be that the will would not be subject to any challenge, because even the successful defense of a will challenge could reduce the value of the estate. A more narrow reading of the promise would be that it was to prepare a will that would not be subject to a successful challenge. In either event, however, the promise to prepare an "invulnerable" will is not predicated upon the general standard of professional care. Further, the alleged promise was to prepare a product with a specific characteristic (*i.e.*, invulnerability). If the product proved not to be as represented, then, regardless of the reasons for that failure, Barker would be liable for breach of contract. As a result, the court found that the plaintiffs had sufficiently alleged a claim for breach of contract and a general claim for negligence.

Analysis

A few things are clear from this case. First, it reestablishes the proposition that, in general, beneficiaries of estate planning documents are "classic" intended third-party beneficiaries, and are therefore able to file negligence claims against the drafters of those documents. There may be certain circumstances under which this is not the case; for instance, if the client were to specifically provide otherwise. However, such circumstances would be extremely rare, and the third-party beneficiary rule undoubtedly applies in the vast majority of cases.

Second, Barker's lack of preparation for the client meeting, together with his acceptance of a will prepared by another lawyer, while understandable, is very troubling. Although the temptation to rely on representations by our friends and colleagues is great, such representations can never take the place of our independent judgment. Therefore, it is not surprising that the negligence claim was upheld by the court of appeals.

What is surprising and troubling, however, is the possibility that all estate planners might be held to the standard of "invulnerability" described in the decision. There is no mention of Barker having actually promised in so many words to make the will invulnerable. Rather, the implied "promise" seems to arise from the general duties of an attorney drafting a will. These duties are spelled out in dicta in the Oregon Supreme Court decision *In re Estate of Manillus Day* 198 Or 518, 257 P2d 609 (1953). This case also involved a lawyer who prepared a will in haste at the request of a beneficiary, and who spent no time meeting with the client in confidence. Although the court was not "disposed to criticize" that lawyer, it issued "a word of admonishment" to lawyers "who let haste or the urgency of other matters suffer them to relax the careful attention which the meticulous preparation of any will demands." A lawyer drafting a will "is required to draw heavily upon his experience and skill," while the client must repose the "fullest faith and confidence in his chosen counsel" in order to "achieve a result consonant with his plans and desires *and invulnerable to afterattack*." *Id*. at 535 (emphasis added). Although not referred to in *Caba*, I understand that *Day* played a role in shaping the plaintiffs' argument.

The language in *Day* can be read in several ways. In its most extreme form, it can imply that any lawyer drafting a will should make it "invulnerable to afterattack." Such an implied promise would be, as any estate planner knows, impossible to make, because many will contests arise from facts unforeseen at the time the will is drafted. A second reading, and one that makes more sense, is that the lawyer must use his or her best efforts to achieve such a goal. Under this reading, the lawyer would not be guaranteeing any particular outcome, only that the lawyer gave his or her best effort and did nothing to make a will contest easier (as Barker did in *Caba*). Finally, the language quoted in *Day* could be read as an admonishment to clients that, if they wish their wills to be "invulnerable to afterattack," they must repose faith and confidence in their lawyer and hold back no information. Indeed, the syntax in *Day* makes this reading perhaps the most likely.

Conclusion

So what is an estate planner to make of *Day* and *Caba*? Are we impliedly promising to make a will invulnerable to contest every time a client executes one, or are we simply promising to give our best effort? At a minimum, I think we can say the following:

- We should never draft a will or oversee its execution under circumstances that would render a contest more likely. Put another way, our best effort might be to pass on the representation in the first place. Clearly, Barker's mere presence as a friend of the beneficiary, who simply adopted language that the beneficiary had prepared, made a will contest far more likely. (Indeed, a contest probably would not have been filed if Barker had not been involved.)
- In keeping with the first item, we should consider the 12 factors in the complaint as circumstances to avoid. This may seem self-evident, but we all at one time have ignored at least one or two of them. Having said that, however, at least one of those factors is not an absolute duty. Estate planners should be wary of audio- or video-taping client signings, because external forces such as lighting can actually make a competent person look worse. Further, we all have had clients who have capacity but who would just look bad on tape. These factors also should be considered.
- Despite the lack of clarity in either *Caba* or *Day*, it is clearly an impossible standard to imply a promise that a testamentary document will be "invulnerable to afterattack." Rather, the appropriate standard should be that a lawyer makes an implied promise to use his or her best efforts to achieve this goal, even if such efforts involve declining the representation in the first place.

In light of this final conclusion, we should each as drafters of wills remember that we are promising to use our best efforts to make a will "invulnerable" with every client.

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- November 15-19, 2004 (Sponsored by ALI-ABA) **Planning Techniques for Large Estates**, San Francisco, CA. Telephone: (800) CLE-NEWS.
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- January 10-14, 2005 (Sponsored by University of Miami School of Law) **39th Annual Philip E. Heckerling Institute on Estate Planning**, Fountainbleau Hilton Resort and Towers, Miami Beach, FL. Telephone: (305) 284-6276.
- January 16-23, 2005 (Sponsored by National Law Foundation) **2005 Mid-Winter Tax and Estate Planning Conference**, The Buccaneer Beach and Golf Resort, St. Croix, U.S.V.I. Telephone: (302) 656-4757.
- January 21, 2005 (Sponsored by the Estate Planning Council of Portland) **34th Annual Estate Planning Seminar**, Oregon Convention Center, Portland, OR. Telephone: (503) 205-2653.

Questions, Comments or Suggestions About This Newsletter?

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Section CLE

Planning the Taxable Estate

November 19, 2004
Oregon Convention Center

Topics Include:

Estate and Gift Tax Planning
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The Annual Meeting of the Estate Planning and Administration Section will be held during the lunch break.

CALENDAR OF SEMINARS AND EVENTS

- October 14-16, 2004 (Sponsored by National Law Foundation) **Great Western Tax and Estate Planning Conference**, The Flamingo Hotel, Las Vegas, NV. Telephone: (302) 656-4757.
- October 15 and October 22, 2004 (Sponsored by Washington State Bar) **How to Probate an Estate and Handle Post-Mortem Matters**, October 15 in Seattle, WA and October 22 in Yakima, WA. Telephone: (800) 945-WSBA.
- October 21-23, 2004 (Sponsored by Southern California Tax and Estate Planning Forum) T**he 24th Annual Southern California Tax and Estate Planning Forum**, Manchester Grand Hyatt Hotel, San Diego, CA. Telephone: (800) 332-3755.
- October 22, 2004 (Sponsored by Oregon Law Institute, Lewis & Clark Law School) **Estate Planning: Fixing the Common Problems**, World Forestry Center, Portland, OR. Telephone: (800) 222-8213.
- October 24-28, 2004 (Sponsored by Chaminade University Tax Foundation and Chaminade University of Honolulu) **The 41st Annual Hawaii Tax Institute**, Sheraton Moana Surfrider Hotel, Honolulu, HI. Telephone: (615) 880-4200.
- October 28-29, 2004 (Sponsored by the Practising Law Institute) **35th Annual Estate Planning Institute**, San Francisco, CA. Telephone: (800) 260-4PLI.
- October 28-30, 2004 (Sponsored by ALI-ABA) **Post-Mortem Planning Estate Administration**, JW Marriot Hotel, New Orleans, LA. (800) CLE-NEWS.
- November 5, 2004 (Sponsored by Oregon Law Institute, Lewis & Clark Law School) **Annual Ethics Update**, Oregon Convention Center, Portland, OR. Telephone: (800) 222-8213.
- November 8, 2004 (Sponsored by National Business Institute) **How to Draft Wills and Trusts in Washington**, Seattle, WA. Telephone: (800) 930-6182.
- November 15-16, 2004 (Sponsored by the Estate Planning Council of Seattle and the Washington State Bar Association) **49th Annual Estate Planning Seminar**, Washington State Convention and Trade Center, Seattle, WA. Telephone (800) 945-WSBA.

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