

Borrowing from the Future? Tapping Restricted and Endowment Funds in a Down Economy

April 30, 2020

As the effects of COVID-19 on the economy and our societal needs present challenges to nearly every nonprofit organization, some organizations are considering how their endowment and other restricted funds may be deployed to address escalating financial stresses. In addition to adapting their fundraising appeals to shorter term and crisis needs, nonprofits must understand the applicable legal restrictions on different types of funds already held by their organizations in order to assess their options for leveraging those assets to address shortfalls in current operating capital. How a nonprofit may tap or leverage funds during an economic decline depends on the type of fund at issue, the specific terms that govern it, and state law.

Legally Binding Endowment Restrictions vs. Board-Designated "Endowments"

Many nonprofits hold funds that are designed to provide long-term financial support to the nonprofit by making annual (or periodic) distributions to the nonprofit while the fund is invested to generate future distributions. Similarly, separately incorporated foundations often hold funds for the purpose of benefitting a designated nonprofit. Nonprofits must understand and identify the legal nature of these "endowment" funds that they hold and which funds may be accessed to support current needs.

- **Only donors can establish binding restrictions.** The only endowment or purpose restrictions that are legally binding are those that are imposed *by donors in a gift instrument*. In almost every state, funds held by nonprofits (including foundations) are generally governed by the version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) enacted in that state.[1] UPMIFA is clear that gift instruments must be in writing, but what constitutes a written gift instrument can be surprisingly broad. Gift instruments include formal documents signed by donors, but also include informal correspondence or even solicitation materials that describe how the nonprofit will use the gifts received in response to the solicitation. Any of the above may impose legally binding restrictions on the use of donated funds.
- **Boards can modify board-imposed restrictions.** Nonprofit boards of directors often decide to hold funds as an "endowment" and not spend down the bulk of the funds on current needs. If these funds have not been restricted by donors, the board of directors may decide to change the use and spending of these "board-designated" or "quasi" endowments and use more of the fund, even the entire fund, to support current needs.

Permissible Spending from Endowment Funds

If a gift instrument contains a specific limitation on the amount of spending from an endowment fund, then the nonprofit must observe that limitation. For example, if a gift instrument says that a nonprofit may make annual distributions of no more than five percent of the fair market value of the fund, the nonprofit may not exceed that limitation.

However, UPMIFA provides that if a gift instrument simply instructs a nonprofit to preserve the fund as "an endowment," to use only the "income," or to "preserve the principal," then UPMIFA's general rules apply. UPMIFA sets forth a somewhat flexible standard that permits a nonprofit to distribute so much of an endowment fund as the nonprofit determines "is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established." In determining a prudent amount to expend, nonprofits must consider the following factors, if relevant:

- The duration and preservation of the endowment fund;
- The purposes of the nonprofit 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;
- Other resources of the nonprofit; and
- The investment policy of the nonprofit.

As a best practice, nonprofits often adopt written endowment spending policies that guide their consideration of these factors. Endowment spending policies commonly call for making annual distributions equal to a certain percentage of the average fair market value of the fund over a defined period — such as five percent of the average fair market value of the fund over the prior 12 quarters.

Basing the distribution amount on an average value of the fund over some prior period is designed to smooth out market fluctuations. However, the steep decline in the stock market in recent weeks may cause distributions for 2020 and into 2021 to drop by an extraordinary and uncomfortable degree if the nonprofit maintains its same spending policy. Conversely, nonprofits may worry that distributing a dollar amount from an endowment similar to amounts in recent prior years will improperly deplete the fund because that dollar amount will be a larger proportion of the total value of the fund due to lower fund values.

Unlike prior laws, UPMIFA does not contain precise requirements or limits on the level of spending from endowment funds. Rather, it emphasizes prudent decision-making and maintaining the purchasing power of an endowment fund while recognizing that nonprofits may appropriately make expenditures from endowments that are the same as prior levels, or even at higher rates, during difficult economic times —

even if the fund has not currently generated similar investment returns and even if the fund balance is "underwater" because it has fallen below the historic dollar value of contributions to the fund.

Boards of directors (or committees designated by a board) must weigh the factors listed above and strike the difficult balance of preserving the enduring value of the fund while meeting immediate needs. The Board or committee should carefully document its decisions in its minutes and describe the factors and data that supported the decision.

Purpose Restrictions

Nonprofits often hold funds that must be used for a specific purpose, such as to support a named professorship at a college or university, maintain a building, support staff training, or to further countless other purposes. Gifts subject to purpose restrictions may be endowed or currently expendable. As discussed above, only restrictions imposed in a gift instrument are legally binding. As COVID-19 has upended many nonprofits' traditional activities, nonprofits may have to think creatively about how to fit their current activities within the scope of a purpose restriction, delay the activity traditionally supported by the gift, or seek to modify the restriction as discussed below.

Lifting a Restriction

If a nonprofit reasonably concludes that holding a fund as an endowment or for its specifically designated purpose is no longer in the nonprofit's best interest, it may pursue lifting the restriction.

- **Board-designated and quasi endowment funds.** To lift a spending or purpose restriction on a board-designated or quasi endowment fund, the Board need only authorize the departure from the terms of the fund it originally set.
- **Donor-designated endowments and purpose restrictions.** If the endowment or purpose restriction has been imposed by a donor, further inquiry will be necessary.
 - **Consult the gift instrument.** The terms of the gift instrument might allow the nonprofit to release restrictions — including a requirement to hold the fund as an endowment — in some circumstances. Nonprofits must carefully consider the specific language of the gift instrument, and any legal enforceability questions, before concluding that they have this power and ensure that any actions taken are consistent with applicable law, the gift instrument, the nonprofit's governing documents, and the best interests of the nonprofit.
 - **Donor consent.** UPMIFA permits nonprofits to release or modify a fund restriction with the donor's written consent. In all cases, the fund must continue to be used for the nonprofit's general charitable purposes, but the donors to a fund may allow a nonprofit to use some or all of an endowment or other restricted fund for immediate needs. This option is unavailable if a donor to the fund has died. If a fund has had a large number of donors or unknown donors, it may be impractical or impossible to obtain consent from each donor.

- **Old and small funds.** UPMIFA also allows a nonprofit to release or modify a fund restriction that has become unlawful, impracticable, impossible to achieve, or wasteful if the nonprofit provides 60 days' notice to the Attorney General (or other charities regulator designated by state law) and the fund is "old and small." Minnesota allows nonprofits to use this option if the fund has a total value of less than \$50,000 and it is more than twenty years old. Missouri sets the thresholds at \$50,000 and 10 years old. Other states have established different requirements.
- **Go to court.** A nonprofit may seek a court order to lift or modify a fund restriction. The standards a court must consider vary by state. Generally, the court may not modify the restriction unless it determines that the restriction has become impracticable or wasteful and courts must generally honor the donor's intentions to the extent possible. The Attorney General (or other official) may participate in this type of court proceeding.

Other Potential Ways to Use Endowment Funds to Meet Immediate Needs

Nonprofits might consider whether they may take a "loan" from an endowment fund. UPMIFA does not directly address this topic. If the nonprofit holds the endowment itself, all disbursements from the fund — including those characterized as loans — are likely subject to the endowment restriction. Accordingly, a nonprofit likely cannot take a loan from its own endowment fund that exceeds the size of a prudent distribution from the endowment.

A nonprofit may use its endowment assets to make loans to other entities if doing so would be a prudent investment. Accordingly, there may be situations when a foundation may make a loan to a nonprofit for which the foundation holds an endowment. UPMIFA sets forth standards nonprofits must consider when making an investment, including loans. Before making a loan to another organization, the nonprofit should consider the potential borrower's creditworthiness, available collateral, and how the proposed loan compares to other investments.

Another issue is whether a nonprofit may use endowment funds as collateral for a loan from a financial institution or other lender. The drafters of UPMIFA suggest that this may be permissible in some circumstances. However, nonprofits should tread very carefully. If a nonprofit pledges its endowment assets as security for a loan and then defaults, the nonprofit may be forced to violate the legal restrictions governing the use of the endowment and risk the wrath of donors and the Attorney General. For this reason, financial institutions may be unwilling to accept endowed assets as security.

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During these trying economic times, nonprofits should think creatively about how to fundraise and tap existing resources to meet their financial needs, while observing compliance with the laws and considerations affecting those concerns. Please contact Wade Hauser, Sheryl Morrison, Greg Larson, Health and Nonprofit Organizations Practice Group Chair Jennifer Reedstrom Bishop, a member of



the Nonprofit & Tax-Exempt Organizations team, or your regular Lathrop GPM contact if you have questions as you navigate these issues.

[1] The versions of UPMIFA enacted by the states contain variations. This article is intended as general information only and references to UPMIFA refer to the model act unless otherwise noted. Seek legal advice regarding specific questions of state law.