Friday, May 8, 2020

It goes without saying that we are living in uncertain times and are experiencing events that are reshaping our lives in ways that many of us believed only to exist in science fiction books and movies. Nevertheless, while we all strive to persevere, the nonprofit community is facing an unprecedented test that hasn't been felt since the Great Depression.

As we think about the health and well-being of our families, communities and friends, the nonprofits that form the underlying fabric of our communities are facing significant financial stress and must make difficult decisions that will, in many cases, define their existence going forward.

With many, if not most, sources of revenue ceasing, nonprofits are asking how to continue to pursue their mission. For those organizations fortunate enough to have an endowment, the question we hear most often is whether or not and to what extent those funds can be used to sustain the organization. While the following is not intended to provide definitive advice, since many factors will influence the ultimate
answer for any organization, we hope this article will help organizations begin to strategically consider the options.

Background

In July 2006, the National Conference of Commissioners on Uniform State Laws (the body which writes “standard” or what is referred to as “uniform” laws for consideration and adoption by the states) approved the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”) and recommended it for enactment by the various states. UPMIFA was designed to replace the original uniform law, known as the Uniform Management of Institutional Funds Act of 1972. The original legislation provided uniform rules for the investment and expenditure of funds held by charitable institutions that were restricted by the donors of those funds. Varying versions of UPMIFA have been adopted in 49 states and the District of Columbia, replacing the original uniform law. The new UPMIFA provides updates of the prudence standards for the management and investment of charitable funds and endowment spending.

UPMIFA is generally designed to provide a framework for the administration of restricted funds held by nonprofits to the extent that the gift instrument is either silent or vague on a particular issue. UPMIFA also updated the rules governing expenditures from endowment funds, providing stricter guidelines and giving organizations the ability to cope more easily with fluctuations in the value of the endowment. In light of the current environment, the issue of expenditure or appropriation from restricted funds has become a hot topic so we review how UPMIFA treats this issue.

As a threshold matter, it is important to remember that funds may be restricted, but that does not necessarily mean that the funds are an endowment fund. Generally speaking, funds that are “restricted” means only that the funds must be used for a particular purpose (e.g., scholarships), while “endowed” funds are restricted funds which will be held for a particular duration (e.g., for 20 years, in perpetuity) and may be drawn upon for application towards the organization’s mission generally or for other specific restricted purposes. In contrast, a restriction imposed by your Board is not the same as a donor restriction, as the Board can simply modify the restriction. Thus, Board restricted funds, typically, are not treated as restricted and may be appropriated as determined by the Board.

Release or Modification of Restrictions

A release or modification of restrictions on a fund, including an endowment, can be achieved either by the current consent of the donor or by a specific process that may be outlined in the gift instrument. In the absence of a specific process in the gift instrument or donor consent, UPMIFA 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 on the management, investment or purpose of a fund has become unlawful, impossible, impracticable or wasteful, the charity may notify the state charitable regulator, and after 60 days, unless the regulator objects, it modifies the restriction in a manner consistent with the charitable purposes expressed in any documents that were part of the original gift. A restriction on larger or more recent
funds may also be modified by court order if the restriction impairs the management or investment of the fund because it has become impracticable or wasteful, or because of circumstances not anticipated by the donor, a modification will further the purpose of the fund. A restriction on the use of larger or more recent funds that become unlawful, impracticable, impossible to achieve, or wasteful can also be modified by a court in a manner consistent with the charitable purposes expressed in the gift instrument.

**Expenditures from Endowed Funds**

UPMIFA, among other issues, provides a framework with respect to expenditures from “endowment funds.” Pursuant to UPMIFA, so long as the expenditures are prudent, looking at all the circumstances, an organization “may appropriate for expenditure or accumulate so much of an endowment fund as the organization determines to be prudent for the uses, benefits, purposes and duration for which the endowment fund is established.” Seven criteria guide the organization in its 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 criteria follow the standards that apply to investment decision-making in other contexts, such as trust investing, making both investment and expenditure decisions more uniform.

Some states, however, have enacted other safeguards against excessive expenditure. For example, some states have adopted provisions that create a rebuttable presumption of imprudence if an organization expends greater than a specified percentage (e.g., 7%) of fair market value of a fund, calculated in an averaging formula over three years. A presumption of imprudence is intended as a reminder that spending at too high a rate could negatively impact the long-term nature of an endowed fund.

It is important to note, however, appropriation from an endowment fund does NOT alter the purposes in which the funds may be used. Funds held in an endowment fund that are restricted to a particular use must still be used for that purpose. Thus, the ability to invade an endowment may not necessarily solve the strain caused by the current crisis.

**Borrowing “Against” An Endowment Fund**
A common question that is often raised is to what extent an organization can “borrow” against the endowment funds. In other words, can an organization invade an endowment and, in effect, promise to repay those funds (with interest) in the future so that the funds may be used for a purpose, other than for which the endowment is restricted. While the ability to take such action will largely be dependent on the state law applicable to the nonprofit, in most states the answer is “no”.

**What Should You Do**

If your organization is in a situation where there is financial stress and you are weighing your options, invading your endowment may be a consideration. You will need to become aware of which version of UPMIFA applies to your endowed funds. After determining the applicable law, your organization’s investment policy and spending/expenditure policies should be reviewed. Restrictions on an organization’s endowment funds should also be reviewed to determine if it would be beneficial to remove any current restrictions on such funds and/or whether invasion is possible. Consider convening your Board (telephonically or by video) to discuss these issues from a financial perspective, organizational perspective, as well as your donor and other stakeholders’ perspectives.

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