

# Surviving the Pandemic: Using Endowment and Restricted Charitable Funds in the COVID-19 Crisis

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# Topics

Charity's Legal Obligation to Comply with Donor Restrictions, even in a Pandemic

Right and Wrong Ways to Use and Access Endowment Funds

Options for Modifying Donor Restrictions



# Issues Faced by Both Operating Charities and Funders

- **Operating charities**
  - Using endowment funds to meet current needs
  - Ability to access use-restricted funds to address greatest need
- **Funders** (foundations, community foundations, Jewish Federations, etc.)
  - Ability to provide funding to operating charities from endowment or use-restricted funds

# Legal Obligation to Comply with Donor Restrictions

- When is a donor restriction legally binding?
  - As a general matter, charities are legally *required to comply* with donor restrictions (such as a restriction that a fund be used for scholarships) made *in writing at the time the restricted gift is made*
  - Donor restrictions may be on *use*, e.g., a restriction for use for scholarships, or on *spending*, e.g., a designation as endowment



# Legal Obligation to Comply with Donor Restrictions

## Donor Restrictions Arising from Solicitations to Donors

- A binding donor restriction will arise if a charity solicits funds from donors and *makes representations in the solicitation materials* that donations in response to the solicitation will be used for a specific purpose (e.g., the Red Cross and 9/11 relief)
- Leave *flexibility in representations* regarding the use of donations



Red Cross Under Heavy Fire  
Over 911 Disaster Funds  
US News & World Report

# Legal Obligation to Comply with Donor Restrictions

## What is *not* a legally binding donor restriction?

- A restriction that a donor seeks to impose *after* the donor has made a completed gift is *not legally binding*
- A donor's *request or advice*, made either at the time of the gift or later, is *not legally binding*

# Legal Obligation to Comply with Donor Restrictions

- Liability for Failure to Comply with Donor Restrictions
  - A charity may be liable for failure to comply with a donor's gift restrictions
  - Erosion of trust and credibility with donors may be more important than actual liability



# Legal Obligation to Comply with Donor Restrictions

- Liability for Failure to Comply with Donor Restrictions
  - Key issue is who has “standing,” i.e., authority, to bring a suit to enforce
    - **Attorney General:** Has standing to enforce restrictions on charitable assets
    - **Donors:** Historically courts have *not* permitted donors to have standing to enforce charitable gift restrictions in actions against charities formed as corporations
    - **Reservation of Enforcement in Gift Agreement:** Courts will *sometimes* permit donors to bring actions if the gift agreement specifically provides for a donor’s right to enforce
    - **Donor’s Family or Heirs:** Generally *do not* have standing





# What is an “Endowment” Fund?

- A fund created by a donor with:
  - a written gift document
  - at the time the donor’s gift is made
  - designating it as “endowment” or otherwise restricting spending, either temporarily or permanently, *or*
- A fund created by donor gifts in response to a charity’s solicitation for “endowment”



# What is *not* an “Endowment” Fund?

- A fund the charity’s board has set aside with an intent not to use for current spending (may be called “quasi endowment”)
- A fund created by a donor where:
  - the donor *recommends* that it be used for endowment
  - the donor seeks to restrict funding *after* the gift is made



# What law applies to Endowment Funds?



- Charitable corporations or charitable trusts for which a charitable corporation is the trustee:  
Uniform Prudent Investment of Institutional Funds Act (“UPMIFA”)
  - Model Act
  - Adopted in 49 states and D.C.

# Permitted Spending from an Endowment Fund under UPMIFA

- Donor-specified spending, e.g.:
  - *Require 10% payout regardless of value*
  - Permit spending *no more than 5%* of net asset value
- Or, if donor does *not* specify, other than by designating as “endowment,” or saying “spend only income,” then UPMIFA requires boards to apply a “**prudence**” standard



# UPMIFA Prudence Standard for Spending

- Core principle is to *preserve purchasing power*
- Spending rate must be “prudent for the uses, benefits, purposes, and duration for which the endowment fund is established”
- UPMIFA does *not* use concepts such as “principal,” “income,” or “historic dollar value”
- More flexible approach that takes modern portfolio theory into account
- But *not* infinitely flexible



# UPMIFA Prudence Standard for Spending

Seven factors to be considered in determining spending rate:

Duration (e.g., in perpetuity) and preservation of fund

Purposes of institution and the fund

General economic conditions

Possible effect of inflation or deflation

Expected total return

Other resources

Investment policy



# What is a Prudent Level of Spending?

- No bright line as to what is prudent; depends on circumstances
- Core principle is to preserve purchasing power
- Some state statutes (e.g., California, New York, Oregon) include a rule under which spending in excess of a fixed percentage (usually 7%) is presumed to be imprudent
- May be possible to rebut this presumption with a strong record
- No presumption that a spending rate *below 7%* is prudent
- Documenting the basis for board decisions is critical



# Critical COVID-19 Endowment Fund Questions

- Can we “borrow” from our endowment fund to pay current expenses?
- Can we pledge our endowment fund as collateral for a loan?
- Can we make loans to other charitable organizations from our endowment fund?





# “Borrowing” from an Endowment Fund to Pay Expenses



- Not addressed or considered by UPMIFA’s drafters
- Such “borrowing” is not legally a loan; a loan requires two parties, and the ability to enforce repayment
- Cannot analyze as an “investment” since the charity is loaning money to itself
- Likely treated as an appropriation from endowment for spending, analyzed under prudent spending standard
- Fiduciary obligation of board to satisfy prudent spending standard

# Pledging Endowment Assets as Security for a Loan

- Official commentary to UPMIFA indicates that UPMIFA permits such a pledge, *subject to a prudence standard*
- Some donors to endowment funds may specifically provide that their gifts may not be pledged
- Some states may require notice to the Attorney General or court approval
- If the charity defaults on the loan and the lender takes the collateral, there may be serious damage to relations with funders and the public
- A charity should be **very cautious** in considering this option



# Loans from Endowment to Other Charities

- Loan is an investment
- UPMIFA standards regarding investment of charitable assets
- “***Prudent Investor Rule***” applies to investment of virtually all charitable assets under UPMIFA (charitable corporations) and Uniform Prudent Investor Act (charitable trusts)



# “Prudent Investor Rule”



- Each person responsible for managing and investing charitable assets shall do so **“in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances”**

# Prudent Investor Rule Factors

Factors to be considered in prudent investment decisions:

General economic conditions

Possible effect of inflation or deflation

Expected tax consequences

Role of each investment in overall portfolio

Expected total return

Other resources

Needs of institution and fund to make distributions and preserve capital

Asset's “**special relationship**” to institution’s charitable purposes

## Other Rules for Investing Institutional Funds



- Management and investment decisions about an individual asset are to be made in context of overall portfolio, not in isolation
- General obligation to diversify investments

# Evaluating Loans from Endowment to Other Charities

- Must satisfy prudence standard
- Percentage of endowment fund involved is relevant
- Overall diversification is relevant
- May take into account an asset's “special relationship” with charitable purposes; not obligated to maximize rate of return on each investment, but ***rate cannot be zero***
- Relationship to mission-related investment philosophy and policy



# Procedures for Modifying Donor Restrictions

- Written Donor Consent
- Court “Cy Pres” Petition
- UPMIFA “Old and Small” Funds
- Non-Judicial Agreements  
(available in some states)





# Procedures for Modifying Donor Restrictions

- **Written Donor Consent**
  - A donor (individual or entity) may agree in writing to release or modify a restriction
  - A donor's *heirs or others* may have authority to release or modify a restriction, but *only if* the donor has provided such authority in the gift document



# Procedures for Modifying Donor Restrictions

## ■ Written Donor Consent

- May be the fastest path to release restrictions in the pandemic
  - Many foundations are releasing restrictions in the crisis
  - Many are sympathetic to organization's plight at this time
- However, obtaining releases may be challenging for a fund with many small donors (e.g., general endowment fund)



# Procedures for Modifying Donor Restrictions

## ■ Court “Cy Pres” Petition

- A charity may petition a court to modify an endowment or use restriction, with notice to the Attorney General, if:
  - The restriction has become impossible, impracticable or wasteful
  - The restriction impairs the management or investment of the fund; *or*
  - Because of circumstances not anticipated by the donor, a modification will further the purposes of the fund



# Procedures for Modifying Donor Restrictions

## Court “Cy Pres” Petition

- Must make the case why the restriction should be released
  - E.g., seeking court permission to use endowment funds to cover operating expenses during coronavirus
- Modified use must be as close as possible to the original donor-intended use



# Procedures for Modifying Donor Restrictions

- **“Old and Small” Funds under UPMIFA:**
  - UPMIFA permits a charity to release or modify a donor’s restriction *without the donor’s consent* with notice to the Attorney General if:
    - The charity determines that the restriction is unlawful, impracticable, impossible to achieve, or wasteful;
    - The restricted fund has a value of **less than certain dollar amount (varies by state)**;
    - The fund is **more than 20 years old**

# Modification of Donor Restrictions under UPMIFA: Old and Small Funds

- **“Old and Small” Funds under UPMIFA:**
  - **Must modify** the restriction **in a manner consistent with charitable purposes** in gift instrument
  - Must provide **60 days notice to Attorney General**
  - No court approval or notice to donor required

# Procedures for Modifying Donor Restrictions

## Non-Judicial Agreements to Modify Donor Restrictions

- Available in some states
- E.g., Washington State’s Trust and Estate Dispute Resolution Agreement (“TEDRA”) Procedures
  - A Washington charity may enter into an agreement with the Attorney General and any named charitable beneficiaries to modify a restriction
  - Requires that the Attorney General and any named charitable beneficiaries actually agree to the change
  - Same effect as a petition and court order





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