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Endowments in Crisis!
Best Practices for Nonprofit Managers To Avoid the Abyss

Endowments are in crisis, threatened by internal challenges such as spiraling administrative costs, proliferating small funds, missing documents, and alignment of revenue, as well as external threats such as poor investment returns, lawsuits, legislation, and potential taxation. Yet endowments are essential to the long-term stability and viability of the nation's nonprofits. In this session, which is a must for nonprofit managers as well as gift officers who solicit endowed gifts, you will learn nine management best practices to improve donor engagement and avoid the abyss.

I. An Overview

A. Before We Begin

Before we begin, let's do a quick analysis of your knowledge, your board's knowledge, and your donors' knowledge of your organization's endowment:

TABLE 1
AN ENDOWMENT QUIZ

The Question	*You Know the Answer*	*Your Board Knows the Answer*	*Your Endowment Donors and Prospects Know the Answers*
1. How large is your endowment?			
2. What portion is true endowment and what portion is quasi-endowment?			
3. What portion is held for general unrestricted distributions and what portion is restricted in purpose?			
4. How many component funds comprise the endowment?			
5. How much, in terms of dollars and as a percentage of the market value, was distributed in 2009?			
6. What is the greatest endowment success story?			
7. What is the minimum size for a new fund?			
8. What were the investment returns in 2007, 2008, and 2009? How is the money managed? How did those returns compare to other like organizations?			
9. What is the greatest current endowment need?			
10. Who makes decisions about how the money is spent, and what are the factors considered in allocating funds?			

B. What Is Endowment?

For the purposes of most discussions, the media and scholars think of endowment as a gift to a nonprofit organization restricted, on transfer, to the use of the gift's earnings. These are permanent funds, the earnings of which may be restricted to a specific use or purpose, or may be unrestricted and used within the discretion of the nonprofit. However, other non-exempt entities may also be considered endowment.

1. Traditional Endowments

There is no real legal definition of endowment. The following dictionary entries are common:

endowment n. the creation of a fund, often by gift or bequest from a dead person's estate, for the maintenance of a public institution, particularly a college, university, or scholarship.[1]

Another description reveals the origin of the term:

ENDOWMENT: The bestowing or assuring of a dower to a woman. It is sometimes used: metaphorically, for the setting a provision for a charitable institution, as the endowment of a hospital.[2]

And a more current definition:

Endowment: A permanent fund bestowed upon an individual or institution, such as a university, museum, hospital, or foundation, to be used for a specific purpose. Endowments may be separately held funds within the charity, or separately established nonprofits holding long-term funds, generally referred to as supporting organizations to the charity.[3]

a. True Endowment

A true endowment consists of funds permanently set aside (by document or otherwise legally restricted) to generate income for the nonprofit. Principal may not be spent. Income may be narrowly defined as the dividends, interest, and rental income from the endowed assets, or more broadly to include realized or unrealized capital gain, depending on state law and the governing document for the funds. When a donor or a court limits the use of endowed funds to a specific purpose, the endowment gift is considered restricted. When the donor leaves spending discretion to the nonprofit, the gift is considered unrestricted. Most endowments consist of a pool of unrestricted funds as well as many small groups of restricted funds pooled for investment purposes.

EXAMPLE: Jerry Jones left a bequest of $250,000 to Northwestern University to provide scholarships for Chicago students attending Northwestern with grade point averages of 3.8 or better on a 4.0 scale. His will specifically provided that the corpus of the gift was to be preserved and that income only was to be used for scholarships.

b. Quasi-Endowment

While a permanent endowment has restrictions on the use of principal, a quasi-endowment does not. Quasi-endowed funds are funds committed to long-term use (endowment) generally by board resolution. Board-restricted funds may include unrestricted bequests or planned gifts received by the nonprofit, surplus funds available at year-end (that are not needed for operating reserves), or funds resulting from the sale of an asset. Since the donor did not restrict the funds, the board can remove its self-imposed restriction and make the principal available for use. Normally, the board will establish procedures to govern distribution of income and withdrawal of principal.

EXAMPLE: Jerry Jones left a bequest of $250,000 to Northwestern University. Although he had contributed to the scholarship program throughout his life, he placed no restrictions on the use of the bequest gift. The board of the University, after discussion, decided to allocate the funds for scholarship purposes to reflect Mr. Jones' lifelong interests.

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[1] http://legal-dictionary.thefreedictionary.com/Endowments.

[2] http://legal.laborlawtalk.com/endowment.

[3] Investorwords.com, www.investorwords.com/1707/endowment.html.

c. Endowment Substitutes

Other permanent pools of charitable funds might also be considered endowments on a functional basis or by legislative definition. Consider the following:

- *Private foundations* - Private foundations are generally considered perpetual entities and are often considered endowments because the funds are invested and the income and earnings are allocated in grants. For example, the Uniform Management of Institutional Funds Act adopted by most states in the 1970's defined endowment as a nonprofit's permanent funds set aside for charitable purposes, the earnings of which were dedicated to the charity's mission. The most recent version of the statute, the Uniform Prudent Management of Institutional Funds Act which was promulgated by the Commissioners on Uniform Laws in 2006 and has already been adopted by more than half the states expands this concept of endowment to include private foundations.

- *Wholly charitable trusts* - A wholly charitable trust is a trust that is invested and makes distributions solely to tax-exempt organizations. These trusts are normally created as exempt organizations (generally a private foundation) and are simply organized in trust, rather than nonprofit corporation form.

- *Supporting organizations* - Many charities hold their endowed funds in separate nonprofit entities, many of which are organized as supporting foundations.

- *Related public foundations* - After the Pension Protection Act of 2006, and the giving limitations imposed on IRA Rollovers and Hurricane Katrina legislation, many supporting organizations were changed to public charities. The public charity holds the endowed assets for the benefit of the nonprofit it was created to support.

- *Community foundation endowments* - A large portion of most community foundations represents permanent funds from which the foundation does grantmaking. These permanent funds may also be considered endowment.

C. The Forces That Threaten Endowments

Endowments, by definition, are perpetual. However, it is impossible to predict today the economic or social climate 100 years from now, much less 1,000 years from now. The current siege was triggered by the difficult economic environment. In an economy struggling to maintain funding of schools, roads, and basic services, endowments - which appear to be large pools of unused funds - are a logical target. Current forces threatening endowments come from a variety of sources, as detailed below. Some of these threats are manageable, while others are not.

1. Congressional Scrutiny and Involvement

Congress, led by the Senate Finance Committee, has placed an unrelenting spotlight on the charitable sector over the last six years, although the spotlight has roamed from charitable tax deductions, to nonprofit operation (conflicts of interest, self-dealing, non-charitable activities). There are clear trends and messages in their work.

a. All Charities Are Equal....But Some Seem More Equal Than Others

While we tend to think of all charities as equal, they are not. In 1969, Congress imposed sweeping changes on the nonprofit sector that created layers of charitable life.

- *The Tax Reform Act of 1969*[4] created a bright line between private foundations and public charities. While Section 501(c)(3) delineates the "charitable sector" - the religious, scientific, literary, educational, and other entities known as charities, Section 509 divides these into two groups: 1) public charities and 2) private foundations. All charities are private foundations unless they fit one of the exceptions in Section 509. The distinction between the two groups was largely based on funding sources and control. Public charities receive broad public support and have boards responsive to the public. Private foundations usually receive funding from a single, or small number, of funders and exercise more control over decision making and operation. While public charities and private foundations are tax-exempt under Section 501(c)(3), private foundations pay an excise tax on their earnings and are subject to the prohibited transaction rules requiring minimum annual distributions, restricting business concentrations, and prohibiting jeopardizing investments and self dealing. Violation of these prohibited transactions rules will result in excise taxes on the foundation and in many cases on the foundation managers.

- *The Katrina Emergency Tax Relief Act of 2005*[5] allowed removed the 50% adjusted gross income limit on cash contributions to charities. It excepted, however, gifts supporting organizations and donor advised funds, two types of gifts under Congressional scrutiny.

- *The IRA Charitable Rollover,* first enacted in 2006 as a part of the Pension Protection Act of 2006,[6] renewed through the end of 2009 in the Emergency Economic Stabilization Act,[7] and currently in front of Congress for extension, allowed individuals age 70 1/2 or older to transfer funds directly from certain IRAs to public charities. Again, gifts to supporting organizations and donor advised funds were excluded from qualified recipients.

- *The Pension Protection Act of 2006* also layered many of the private foundation prohibited transaction rules on supporting organizations and donor advised funds, in addition to creating new restrictions. Type III Supporting organizations - under the temporary regulations created in the wake of that act - will now be required to make a minimum annual distribution similar to that required of private foundations and it is possible donor advised funds will be required to comply with similar rules.

This distinction between good and bad, or better and lesser, has continued and now threatens to create distinctions within the public charity sector. The tone and focus are seen in the proceedings of The Senate Finance Committee which in 2006 began a series of hearings on the nonprofit sector. The Senate Finance Committee staff published a draft prior to the first meeting in June that outlined a wide range of reforms for the nonprofit sector, aimed at abuses on taxpayers and nonprofit entities. This draft is telling in the scale of the reforms proposed and is must reading for anyone working in the nonprofit sector.[8]

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[4] Pub. L. No. 91-172, 83 Stat. 533 (December 31, 1969).

[5] Pub. L. No. 109-73, 119 Stat. 2016-1029 (September 23, 2005).

[6] Pub. L. No. 109-280, 120 Stat. 780 (August 17, 2006).

[7] Pub. L. No. 110-343, 122 Stat. 3765 (October 6, 2008).

[8] http://finance.senate.gov/imo/media/doc/062204stfdis.pdf.

b. The Non-Profit Hospital Sector Inquiry

September 12, 2006: In May 2005, Senator Chuck Grassley contacted 10 major nonprofit hospitals in his ongoing effort to "review the non-profit sector in advance of legislation he will introduce to prevent abuse of the federal tax laws that created non-profit organizations and encourage charitable donations."[9] The selected institutions[10] were asked to answer questions that focused on charity care policies, the charity profile of each member of the hospital group, research and teaching, fundraising activities (specifically for the poor), compensation arrangements with physicians and other professions, community outreach, clinical trials, payments/charges/debt collection, and allocation of expenses.

c. The Higher Education Inquiry

In late 2007, the Senate Finance Committee led by Senators Max Baucus (D-MT) and Chuck Grassley (R-IA), began an investigation of higher education that included compensation, endowment spending, and related issues. This inquiry came on the back of the National Association of College and U. S. Business Officers endowment report that 76 colleges and universities closed the 2007 fiscal year with endowments above $1 billion,[11] double digit endowment returns for the broader group of colleges and universities, and increasing investments in hedge funds and other sophisticated financial instruments while distribution rates were not increasing. At the same time tuition costs and executive compensation were rising.

The Senate Finance Committee sent letters and questionnaires to 136 large university endowments of $500,000 or more. The inquiry had a simple premise: "Tuition has gone up, college presidents' salaries have gone up, and endowments continue to go up and up. We need to start seeing tuition relief for families go up just as fast."[12] Senators Baucus and Grassley advanced a proposal that large university endowments (endowments of $500 million or more) have a mandatory 5 percent distribution requirement like private foundations to maintain tax exempt status.[13] Sen. Grassley stated: "Congress would be remiss if it didn't question what benefits tax-exempt colleges and universities provide in return for all of the federal benefits they receive." Congressional thoughts seems to run along the lines of tuition reduction, lower salaries for administration, and similar reductions in cost that would make a college education more affordable."[14] Table 2 shows the growth of the twenty top university endowments from 1990 to 2008.

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[9] 'Grassley Asks Non-profit Hospitals to Account for Activities Related to Their Tax-exempt Status," (May 25, 2005), http://finance.senae.gov/newsroom/chairman/release/?id=f9c0050b-521b-4577-9af9-9cdecabfa358.

[10] Advocate Health Care Network (and Hospital Corporation), Oak Brook, Illinois; Resurrection Medical Center (and Health Care), Chicago, Illinois; Phoebe Putney Health Systems, Inc. (and Memorial Hospital) Albany, Georgia; William Beaumont Hospital and Hospital Properties, Royal Oak, Michigan; North Mississippi Health Services, Inc. (and Medical Center), Tupelo, Mississippi; Sutter Health, Sacramento, California; Fairview Health Systems, Minneapolis, Minnesota; and Banner Health, Phoenix, Arizona.

[11] National Association of College and U.S. Business Officers, 2007 NACUBO Endowment Study, pp. 54-56, available (for a fee) at http://www.nacubo.org.

[12] United States Senate Committee on Finance, "Baucus, Grassley Write to 136 Colleges, Seek Details of Endowment Pay-outs, Student Aid," (January 24, 2008), http://finance.senate.gov. The letter sent to the 136 colleges and universities is a part of this press release.

[13] Drawbaugh, Kevin, Rich college funds draw Congress tax scrutiny, Reuters (October 24, 2007), http://www.reuters.com/article/idUSN2427438120071024.

[14] United States Senate Committee on Finance, http://finance.senate.gov.

TABLE 2
TOP UNIVERSITY ENDOWMENT BALANCES 1990 AND 2008[15]

School	*1990*	*2008*
Harvard	$4,653,229,000	$36,926,693,000
Princeton University	$2,527,140,000	$16,727,060,000
Yale University	$2,570,892,000	$22,686,282,000
California Institute of Technology	$523,729,000	$1,664,320,000
Massachusetts Institute of Technology	$1,404,588,000	$10,068,787,000
Stanford University	$2,053,128,000	$17,214,373,000
University of Pennsylvania	$808,409,000	$6,233,271,000
Columbia University	$1,494,938,000	$7,146,806,000
University of Chicago	$1,074,505,000	$5,933,760,986
Duke University	$472,923,000	$6,123,843,000
Dartmouth College	$593,952,000	$3,944,328,836
Northwestern University	$983,556,000	$5,342,297,000
Washington University in St. Louis	$1,365,854,000	$5,428,641,000
Johns Hopkins University	$560,478,000	$2,475,722,000
Cornell University	$926,900,000	$5,578,101,861
Brown University	$425,750,000	$2,778,022,000
Emory University	$1,153,875,000	$5,515,479,092
Rice University	$1,068,633,000	$4,609,863,000
Vanderbilt University	$603,708,000	$3,495,439,000
University of Notre Dame	$605,630,000	$6,351,855,000

The full focus of the inquiry coincided with a major downturn in the markets. Many college and university endowments lost 25% to 30% of their asset values in 2008 with the largest endowments (holding hedge funds) suffering some of the greatest losses. Harvard's endowment, for example decreased from $36 billion to $26 billion, a 27.8% decrease. These deep tumbles, and a change of power in Washington, seemed to have temporarily toned down the inquiry.

[15] Endowment data for 1990 were obtained from the National Association of College and University Business Officers (NACUBO). Endowment data for 2008 were obtained from U. S. News and World Report. Herwig Schlunk, *An Argument for the Repeal of Tax Preferences for Educational Endowments* (Working Paper Number 09-37, Vanderbilt University Law School Law and Economics), p. 12.

d. Conflicts of Interest

Discussion of conflicts of interest is simply a discussion of private benefit from public funds. While Congress is focusing on misuse of charitable funds, the media has focused on conflicts between legislators, the for profit companies who have a legislative agenda and who fund charities, and the charities who honor lawmakers. A recent *New York Times* article reported on links between university endowments honoring almost a dozen current and former members of Congress that were funded in part by corporations with federal legislative interests.[16] Consider a few examples highlighted in the article:

- An endowed chair at the University of Hawaii honoring Senator Daniel K. Inouye (D-HI) $100,000 of the chair's endowment was contributed by a cruise ship line the Senator had helped with legislation to expand its U.S. ports of call.[17]

- A University of Louisville endowment created to honor Senator Mitch McConnell (R-KY) - several hundred thousand dollars were contributed by a military contractor that received a $12 million earmark sponsored by Sen. McConnell.[18]

- Rep. Charles B. Rangel used Congressional letterhead to solicit companies with business in front of the Ways and Means Committee to contribute to the Charles B. Rangel Center for Public Service at The City College of New York.

- FMC Corporation, a chemical company that produces a produce used in road products to prevent cracking has made three contributions to a Minnesota law school endowment honoring Rep. James L. Oberstar. Rep. Oberstar is the chair of the House Transportation Committee.

At the same time, a 2010 study conducted by Tellus Institute, a social policy institute located in Boston, Massachusetts, found conflicts on university boards and the investment management firms who managed the universities' endowments. In the study, Tellus Institute made an examination of six top universities was used to formulate opinions and policy about the role of big university endowments in the financial crisis.[19] The study concluded these large endowments held such large positions of speculative investments that the endowments helped create the recent financial crisis. That study also found seven Dartmouth trustees or committee members with disclosed conflicts of interest since 2004.[20] These conflicts related to employment positions with direct connections to funds in which the endowment was invested.

2. Taxation of Endowments

Endowments - especially large endowment - may also be threatened by taxes. Some state and local governments that are falling short of tax dollars have targeted endowments as an easy way to solve revenue problems.

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[16] Lipton, Eric, Corporate Funds Aid Centers Tied to Lawmakers, The New York Times (August 5, 2010), www.nytimes.com/2010/08/06/us/politics/06endowment.html?_r3&hp.

[17] *Id.*

[18] *Id.*

[19] Educational Endowments and the Financial Crisis: Social Costs and Systematic Risks in the Shadow Banking System - A Study of Six New England Schools, Tellus Institute, Center for Social Philanthropy, www.tellus.org/publications/files/endowmentcrisis.pdf, (2010).

[20] *Id.*, p. 41. Source: New Hampshire State Department of Justice, Charitable Trusts Unit; and Tellus Institute.

a. State and Local Income Taxes

The Cambridge City Council, in 2005, proposed an endowment tax for the nonprofits located in the city. (Harvard, MIT). MIT was already giving Cambridge a payment in lieu of taxes (PILOT) of $1.2 million with a 2.5 percent increase each year (negotiated in 2004).[21] The state of Massachusetts, in 2008, proposed a 2.5 percent annual assessment on colleges with endowments over $1 billion which hey expected would raise $1.4 billion per year.[22] (This would have cost Harvard $840 million annually based on the endowment's value at that time.)[23] While the tax failed, this will likely continue to be an appealing option since Massachusetts had at least 9 colleges with endowments in excess of $1 billion in August 2010.[24]

b. Other Non-Endowment Taxes

Endowments holding real property may also be subject to property taxes or property tax substitutes in some localities. Consider the following representative actions:

- The Princeton Borough, in which Princeton University is located, is contemplating a property tax on land owned by Princeton.[25] In 2008, Princeton paid more than $10 million to the community which included $8.2 million in property taxes on commercial ventures and a voluntary payment to the community,[26] but local officials feel it should pay more. (Princeton owns 43 percent of the borough's assessed land value and 13 percent of the adjoining Princeton Township's assessed land value.)[27]

- A Boston task force is assembling a plan that would require nonprofits to make annual payments equal to 25 percent of the amount they would have paid in property tax had that been taxable.[28]

- In Pittsburgh, the mayor threatened to tax tuition payments. A number of nonprofits such as Carnegie Mellon, University of Pittsburgh, and others.[29]

3. The Investment Markets

The investments markets have also taken a toll on endowments and spending power. While the markets have significant driven endowment size through the 1990's and in segments of the 2000's, the more recent decade has brought with it more peaks and valleys and more risk. Large endowments have larger investment pools and

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[21] He, Ray C., Cambridge Seeks to Tax Earnings on Endowment, The Tech (October 4, 2005), http://tech.mit.edu/V125/cambsurcharge.html.

[22] Schworm, Peter and Matt Viser, Lawmakers target $1 billion endowments, The Boston Globe (May 8, 2008), http://www.boston.com/news/local/articles/2008/05/08/lawmakers_target_1b+endowments/.

[23] Hechinger, John, College Endowment Tax is Studied, The Wall Street Journal (May 9, 2008), http://online.wsj.com/article/NA_WSJ_PUB:SB12102857969979023.html.

[24] Hemphill, Paul, Argh! Tax Exempt Status for 9 Massachusetts Colleges with Billion Dollar Endowments, Ezine Articles, http://ezinearticles.com/?Argh!-Tax-Exempt-Status-For-9-Massachusetts-Colleges-With-Billion-Dollar-Endowments&id=1263987. The nine colleges include Amherst, Boston College, Boston University, Harvard, MIT, Smith, Tufts, Wellesley, and Williams.

[25] Herbst, Moira, Princeton a "Hedge Fund' Foils Residents Seeking Relative Share of Taxes, Bloomberg (June 28, 2010), http://www.bloomberg.com/news/2010-06-29/princeton-as-hedge-fund-foils-residents-seeking-relative-share-of-taxes.html.

[26] *Id.*, Princeton first made a voluntary payment of $10,000 in 1964 and has slowly increased the amount culminating with a six year payment-in-lieu-of-taxes formal agreement of more than $1 million.

[27] *Id.*

[28] *Id.*

[29] *Id.*

therefore often take more risk by investing in "alternative" investments such as hedge funds, private equity, and real estate. A look at the returns by sector over the last decade provides some insight.

TABLE 3
MARKET RETURNS 1999 - 2009

Index	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*
Stocks											
DJIA	25.22%	-6.18%	-7.10%	-16.76%	25.32%	3.15%	-.61%	16.29%	6.4%	-33.8%	18.8%
S&P 500	19.53%	-10.14%	-13.09%	-23.37%	26.38%	8.99%	3.00%	13.62%	3.5%	-38.5%	23.5%
NASDAQ	85.50%	-39.29%	-21.05%	-31.53%	50.01%	8.59%	1.37%	9.52%	9.8%	-40.5%	43.9%
DJ World (excluding US)	31.54%	-17.36%	-21.02%	-15.63%	38.58%	19.23%	14.40%	23.01%	11.8%	-46%	37%
Bonds											
Long Treasury Bond*	-15.13%	20.11%	3.50%	14.62%	1.38%	5.06%	2.7%	1.85%	10.12%	20.64%	-13.17%
Municipal – Tax Free	-6.34%	17.10%	4.50%	10.73%	2.54%	5.45%	3.9%	4.4%	4.18%	.54%	9.4%
Corporate – Investment Grade	*-1.89%*	*9.10%*	*10.70%*	*10.17%*	*8.31%*	*5.41%*	*2.00%*	*4.3%*	*4.56%*	*-6.54%*	18.68%
Corporate – High Yield	*2.51%*	*-5.10%*	*4.50%*	*-1.89%*	*27.23%*	*10.76%*	*2.70%*	*10.7%*	*2.57%*	*-25.23%*	58.10%

Losses at big endowments have been widely covered by the media. A review of endowment investment practices by Joshua Humphreys for the Center for Social Philanthropy in Boston, found many universities were very aggressive in investing endowment assets, and that by embracing the additional risk they subjected their nonprofits to more volatility which he felt was in contradiction to their goal to preserve assets. Final figures for 2009 were dismal as shown in Table 4.

TABLE 4
MARKET VALUE OF ENDOWMENTS FOR THE TEN UNIVERSITIES WITH THE LARGEST ENDOWMENTS[30]

University	*2008*	*2008*	*Change*
Harvard University	$36.6 billion	$25.7 billion	-29.8%
Yale University	$22.9 billion	$16.3 billion	-28.6%
Stanford University	$17.2 billion	$12.6 billion	-26.7%
Princeton University	$16.3 billion	$12.6 billion	-22.8%
University of Texas	$16.2 billion	$12.2 billion	-24.8%
University of Michigan	$7.6 billion	$6.0 billion	-20.7%
Columbia University	$7.3 billion	$5.9 billion	-19.8%
Northwestern University	$7.2 billion	$5.4 billion	-24.8%
University of Pennsylvania	$6.2 billion	$5.2 billion	-16.8%
University of Chicago	$6.6 billion	$5.1 billion	-23.2%

[30] Lewin, Tamar, "Investment Losses Cause Steep Dip in University Endowments, Study Finds, New York Times (January 28, 2010), p. A13.

4. Use of Endowed Funds for Purposes Other Than Intended

There are three primary reasons endowed funds are allocated to purposes other than those directed by the donors: 1) the nonprofit is careless and unaware the document is restricted, 2) the nonprofit intentionally redirects funds, or 3) the document's directed purpose is no longer relevant, appropriate, or necessary.

a. The Nonprofit Unintentionally Redirects Funds

Large endowments are comprised of hundreds or thousands of small funds, each of which may have restrictions or directives on the use of funds. Harvard, for example, reported more than 11,600 separate endowment funds in its latest annual report. Much can happen for charities to stray off the donor's directed path. The document may get lost. The charity may simply be overwhelmed by the number of funds and be unable to assure appropriate use. Or the charity may simply get careless in the allocation process.

b. The Nonprofit Intentionally Redirects Funds

The Metropolitan Opera, after reaching a financial crisis, asked donors to remove restrictions from $22 million of restricted, endowed funds so that it could use those funds to cover operational expenses.[31] While the Opera did ask donor's permission (and in the end used a third of those funds to keep the doors open and Opera functioning), this was clearly not the use anticipated by donors or the Opera when the gift was created.

Other institutions, that have exercised great discipline in assigning otherwise unrestricted bequests and excess cash at year end to quasi-endowment have also been quietly spending down endowment.[32] In Birmingham, Alabama, the board of trustees of Birmingham Southern College recently learned the school had run major deficits for more than five years and had been using endowed funds and bank loans to fill the gap.[33] While the trustees appeared surprised and the finance office had apparently not been transparent about the source of funds used to fill the gap, the information on deficit spending was available on the school's Form 990.

c. The Restricted Purposes Are No Longer Appropriate

Across the county, donors - and descendants of donors - are suing charities for misappropriate or inappropriate use of endowed funds. Some of the more familiar cases are described briefly below.[34]

1) *Tulane University and the Sophie Newcomb Family.* From 1886 to 1901, Josephine Louise Newcomb contributed over $3.6 million to create the Sophie Newcomb College in Tulane University to advance "the cause of female education in Louisiana." The gift, worth approximately $75 million in today's dollars, established the first separate college for women in a university in the United States. After Katrina temporarily closed Tulane in 2005, the Trustees voted to merge Newcomb College into Tulane and to absorb its endowment and create a women's studies department within Tulane. The heirs of Josephine Newcomb filed suit to enforce Ms. Newcomb's intent in maintaining a separate college. After a series of skirmishes related to standing to sue, including a second set of

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[31] Orden, Erica, met Opera moved Millions from Endowment in 2009, The Wall Street Journal (April 28, 2010), http://online.wsf.com/article/SB10001424052748703465204575207980829121558.html.

[32] This is anecdotal rather than established through survey. In my experience, from 40% to 60% of an endowment is generally comprised of quasi-endowment rather than true endowment.

[33] Garrison, Greg, "Birminghm Southern College President David Pollick is on hot seat as school budget woes boil," The Birmingham news (August 1, 2010), www.blog.al.com/spotnews/2020/08/birmingham-south_college_pr_1.html.

[34] For a more in depth coverage of issues related to donor intent, see Kathryn W. Miree, "Perfecting Donor Intent," available from the author.

heirs who filed suit, the case is still in litigation. The case history and court filings can be found at www.newcomblives.com.

2) *The Robertson Foundation Lawsuit Against Princeton.* Charles and Marie Robertson[35] contributed $35 million in A & P stock to Princeton University in 1961 to create a supporting organization to fund the Woodrow Wilson School of Public and International Affairs "where men and women dedicated to public service may prepare themselves for careers in government service, with particular emphasis on the education of such persons for careers in those areas of the Federal Government that are concerned with international relations and affairs."[36] Specifically, they wanted to produce high-level foreign diplomats. The Foundation has provided a substantial portion of the operating budget of the Woodrow Wilson School at Princeton, but has also funded other budgets, including a $13 million principal distribution to build Wallace hall, a building designed to house the expansion of the Woodrow Wilson School as well as other school programs. The Robertsons died in 1972 and 1981, but their children and a cousin filed suit in 2002 alleging the school had intentionally violated the donors' intent and was engaged in self-dealing with regard to investments and distributions; they asked the court to redirect the funds to other universities that could fulfill the donors' goals. The lawsuit involved numerous depositions and other discovery costing Princeton over $40 million in expenses through December 2008.[37] The lawsuit was settled on December 10, 2008, and approved by the court on December 12, 2008. The settlement required Princeton to transfer $90 million plus interest to a new Foundation for the specific purposes advanced by the donors. [38]

3) *The Barnes Foundation.* Dr. Albert C. Barnes established the Barnes Foundation in 1922 to house his extensive Impressionist, Post-Impressionist and early Modern art collection (including many masterpieces with a collective current value of $6 billion)[39] and to educate the working class about art. The collection – which was assembled and mounted by Dr. Barnes – was located in a modest structure in Merion, Pennsylvania, a Philadelphia suburb. Dr. Barnes arranged the paintings and designed the art education curriculum himself. He did not intend to have the entity operate as a traditional museum.[40] Dr. Barnes died in 1951. In 1991, the trustees went to court to amend the Foundation's governing documents which prevented the trustees from selling or loaning the art in the collection.[41] While the lawsuit – which cost the Foundation about $10 million in expenses – did not result in a change in the Foundation's by-laws, the Judge did allow the Foundation to take the art on tour raising about $16 million for renovations.[42] In September 2002, the financially-strapped trustees filed another lawsuit seeking permission to move the art collection from the Merion building to a new building (to be constructed) in downtown Philadelphia; in addition, it asked the Court to allow it to expand the number of trustees from 5 – as designated by Dr. Barnes in the governing

[35] Mrs. Robertson was the daughter of the founder of the A & P grocery chain.

[36] The language setting out the Foundation's purpose is taken from its Certificate of Incorporation. To provide context, in 1961 the U.S. and Russia were engaged in a cold war, the United States was involved in Vietnam, and President Kennedy was asking American to "ask not what your country can do for you – ask what you can do for your country."

[37] Hathirimani, Raj, Robertson Lawsuit Most Expensive in University History, Dailyprincetonian.com (November 19, 2004).

[38] "Robertson Lawsuit Settled," http://paw.princeton.edu/issues/2009/01/28/pages/7658/index.xml.

[39] The Foundation also owns works by Manet, Degas, Seurat, Prendergrast Titian and Picasso.

[40] According to the Foundation's press release the Foundation has a 3-year horticulture program, and a 2-year art and esthetics program with a 1-year seminar extension.

[41] Solis-Cohen, Lita, Maine Antiques Digest, March 2004 <http://www.maineantiquedigest.com/articles/mar04/barnes0304.htm>.

[42] *Id*.

documents – to 15.[43] The court ultimately approved the increase in the number of Trustees and the request to move the Foundation's art gallery from Lower Merion Township, Pennsylvania to a new location in downtown Philadelphia. The court's 41- page published opinion[44] acknowledged the changes ran counter to the terms of the Foundation's 1922 charter and governing documents but noted there was "no viable alternative" for the financially-compromised charity.[45]

The cases are less a reflection of charities-gone-wild and more a set of cautionary tales for drafters. Donors are often narrowly focused in the restrictions they place on gifts. The gifts also reflect the social, economic, and sometimes political environment of the time of the gift. They are doomed to fail eventually, because the social, economic, and political environment is bound to change. Consider a major endowment gift to buy books and periodicals for a school library. If the gift was made in the 50's, 60's, 70's, or even 80's, the library's primary expense (other than staff) was likely acquisition of books. Today the big library expenditures have to do with electronic formats, electronic access, and connectivity to other libraries. The gift restricted to books would have little value unless the gift provided enough flexibility to cover the new medium.

D. The Role of Endowment in Today's Environment

1. The Dream

Every nonprofit has a slightly different perspective on the role of endowment. The dream, of course, is to have an endowment that is an endless resource. It covers operations. It covers the design of a new building. It covers the cost of the move to the new building. It covers the cost for the first few years of new programs and projects. This is an easy dream to cling to because it relieves the Executive Director or President of the nonprofit of the responsibility to fundraise, it relieves the board of the responsibility to fundraise, and everyone's time can be allocated to spending the money gushing from the endowment. This is both unrealistic and potentially dangerous to the nonprofit's tax status. First, there will always be a need for fundraising, including capital campaigns, for which donors must be identified, cultivated, and engaged. (Otherwise, there will be no donors to go to for the campaign.) This is an ongoing, year over year effort. Second, charities that must meet the 33 1/3 percent test for public charity status will fail if they stop raising funds and rely solely on endowment. Third, having to "make the case" for support on an ongoing basis keeps you focused and aware of your public duty.

2. Defining the Role of Endowment

Defining the work of the endowment in achieving mission will result in different perspectives at each charity. However, each one must articulate the internal case for support. Generally, an endowment serves as:

a) A way to ensure services will not be reduced as revenue drifts down in tough economic times;
b) A way to leverage current resources to expand the charity's reach;
c) A resource pool for new or start up projects to cover the early expenses until other fundraising activities catch up;
d) A way to ensure organizational quality through a pool for strategic planning, board development, or organizational retreats and planning sessions; and
e) A way to go beyond the basics and add depth to programs, or staff skills, or similar resources.

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[43] *Id.*

[44] *The Barnes Foundation,* No. 58,788 (12/13/04).

[45] Blum Debra E. Court Ruling Could Influence Restrictions Donors Place on Bequests, *The Chronicle of Philanthropy* (January 6 2005; Court Allows Barnes Foundation To Move Collection to Philadelphia, *Nonprofit Issues* December 16, 2004 – January 15, 2005 <www.nonprofitissues.com/public/features/leadfree/2004dec2-IS....>

D. A Survey of Endowment Managers: The Most Common Problems

While many of the endowment problems I see are related to large charities - those with the largest endowments - smaller charities struggle with the same issues, just not on the same scale. These are the most often-cited problems:

1) **Administrative costs that represent too large a percent of the revenue produced by endowment.** Managing an endowment takes time, money, people, and systems to account for the funds (especially segregated funds for specific purposes), allocate revenue to the purpose and document it, investment the monies, allocate gains/losses/fees/additions/distributions to each of the segregated funds in appropriate ratios, report to donors, provide information in audits, report the fund balances appropriately on the financial statement, and in some cases, produce reports on individual funds.

2) **Proliferating and scattered funds.** Many charities allow donors to restrict income, and provide segregated funds at levels as low as $5,000. This leads to a spiraling number of funds, dramatically increases the costs of management, opens the door for missteps in use of funds, and invariably limits the effectiveness with which the charity can report to donors.

3) **Managing the paperwork.** Harvard, at my last count, had 11,600 endowment funds. That's a lot of paperwork. Some charities don't think about how the documents will be housed, how they can be accessed (although with scanning, the answer is easy), and who is responsible for holding them, producing them when needed, and overseeing their safety.

4) **Allocating restricted funds to designated purposes (and proving it!)**. Allocating the funds, and documenting that allocating in a way that makes it easy to audit, and easy to produce in the event of a challenge to the use of funds, is harder than it looks, especially when there are so many funds. A $5,000 fund will distribute $200/year with a 4% distribution rate. It will cost more than $200 to separately track the fund, allocate the revenue, document that allocation, and report to the donor. It is easy to drift off course if someone is paying close attention.

5) **Funds that outlive their purpose.** For charities, it is difficult when endowments require that the charity offer and operate programs that are no longer used to achieve mission, or the needs have changed in a way that the fund no longer has value for the charity. The earlier cautionary tales involving Princeton, the Barnes Foundation and Tulane make this point.

6) **Negative investment returns.** Many planning sessions for charities assume endowment values will go up. As we have learned in the last decade (see Table 3) this is not always the case. In fact, the DJIA, in August 2010, is lower than its value at the end of 2000, a decade earlier. Under Uniform Management of Institutional Funds Act (UMIFA), spending was limited when endowments were underwater (under the historic dollar value limitation). In the last 4 years, most (but not all) states have moved to the Uniform Prudent Management of Institutional Funds Act (UPMIFA) which removed the historic dollar value rule and instead allowed nonprofits to exercise discretion (and prudence) in making distribution decisions. Neither help if negative returns continually shrink the non-inflation-adjusted value of the endowment funds.

7) **Litigious donors.** Finally, litigious donors create problems for charities. The lawsuits discussed earlier add one perspective, but a parade of unhappy endowment donors can be just as debilitating.

The charity's goals should be to anticipate these common problems, and create an endowment creation, administration, and spending structure that heads off bad results.

II. The Nine Endowment Best Practices

A. Best Practice #1: Adopt a Clear Case for Endowment Support

1. The Internal Case

You will need to make the internal case to your board and staff to help them understand the role and impact of endowment and Legacy giving on your organization's capacity to achieve mission. That case must be compelling, urgent, and relate to outcomes as a result of the investment. Without internal buy in, you will find it difficult to impossible to maintain a consistent, effective program.

There is no purely objective test that leads an organization to decide to establish an endowment. Consider the following questions. Positive answers to any of these questions may lead the organization to consider the creation of an endowment:

- *Does the organization serve a purpose or need that is likely to exist on a long-term basis?*
- *Do cyclical economic variances impact the receipt of annual or special event gifts?*
- *Does the organization face increasing operating costs?*
- *Does the organization currently have new programs related to its purpose that cannot be operated because they lack funding?*
- *Does the organization anticipate future needs for programs that may not be met for lack of funding?*
- *Does the organization face increasing competition for annual gifts?*
- *Is the organization dependent upon government or private grants for its organizational expenses?* .
- *Has the organization lost major annual gifts through attrition of its donors?*

Do not assume that your board and staff agree that endowment and Legacy giving are appropriate. The most common objections held by board members include the following:

TABLE 5
SIX MOST COMMON ENDOWMENT MYTHS

Common Endowment Concern	*The Answers!*
1. How can we justify planning for/soliciting gifts for tomorrow when there are so many unmet needs today? Shouldn't we allocate every dollar we can raise to address today's problems?	Boards have a fiduciary duty to ensure continuity of services. An endowment allows the board to continue services through fluctuations in the economy, to expand programs strategically and with certainty the funding will be there to continue those programs, and to have resources when there are emergencies or disasters.
2. An endowment may make the organization appear rich? How do we get donors to continue giving annually if we have an endowment?	The endowment must have structure and purpose, including long-term goals. Once these are established, donors will understand the purpose and context of their gift, and the role of endowment.
3. How do we get donors to give us unrestricted dollars? We really don't want dollars directed to specific purposes because it will be too restrictive.	Structure the endowment to allow donors to give to broad areas of mission without restricting dollars to specific programs or activities. Long-term this will give their Legacy gifts the greatest impact.
4. Won't donors quit giving to us annually, or in capital campaigns, if they make an endowment gift? How do we avoid this?	Donors will not quit giving annually unless you ask them to do so! Make it clear their annual gifts are critical in supporting current mission, and you do not want them to make an endowment gift it will compromise that annual gift. Keep annual, capital, and endowment giving separate – recognize them separately in your giving societies and annual report.
5. Endowment and legacy giving are complicated concepts. Why don't we just stick to the basics, such as outright cash gifts?	If donors are restricted to cash, their options are limited. By expanding gift asset options, and gift form options, you increase the likelihood the donor will be able to participate.

6. How do we justify the costs for staff, marketing, and support of the Legacy program? You've told us these Legacy gifts will not be realized for many years.	Investing in Legacy and endowment giving is an investment in the future of your organization, as critical a contribution as the dollars that operate your programs today. Because there is a lag time between program start up and the realization of significant cash flow, you cannot wait until you are in crisis to begin.

2. The External Case

The external case for support should communicate to donors why they should consider and create an endowment gift. This statement should motivate the donor, excite and inspire the donor, and clearly communicate that donor's role in the future of your community.

One of the clearest, most compelling cases for endowment was made by Ray Lynn Wilbur, President of Stanford University at the outset of the University's 1922 Campaign:[46]

> *Stanford University is making a new decision which will determine its future for all time. The University has reached the limit made possible by the Stanford Fortune. If it is to go forward and upward it can only do so through the support of every member of the Stanford Family and of the public in general. Stanford now takes its place among the great national universities of this country. . .*
>
> *Independent, self-contained, apparently rich, the University has gone its way to the best of its ability, making limitations in various ways, including the number of students accepted, so that the work done could be on a satisfactory plane. Not to grow is in part to die. The University must have increased facilities, more buildings, and more advantages; must keep step with educational progress, just as a growing boy must have new clothes and new facilities as his capacity to do more increases with age. . .*
>
> *There is every reason to anticipate that we can obtain the same help that has come to similar institutions elsewhere. Stanford is the one great privately endowed university west of St. Louis. Certainly from this vast territory there will come the interest and help that is needed. . .*
>
> *If we can work together for Stanford and Stanford's progress we can rest assured that within another generation no institution in the country will have better facilities, a better reputation, or achieve better results in education.*

This statement has vision. It draws on the university's strategic plan (think of your community's "Next 100 Years" plan.) It challenges and engages those invested in Stanford. It is short and easy to read. It overcomes perceptions the University is rich. It clearly describes the outcome of the donor's investment.

B. Best Practice #2: Organize the Endowment to Communicate Vision and Set Goals for Each Endowment Sector

1. Create Sectors To Reflect the Organization's Mission

Organize the endowment in the four to five sectors that reflect the organization's work. These should be broad sectors that will not change over time. The sectors should be defined enough to allow donors to know how their funds will be used, but flexible enough to allow the nonprofit to spend broadly within that sector. Consider this example for a college preparatory school:

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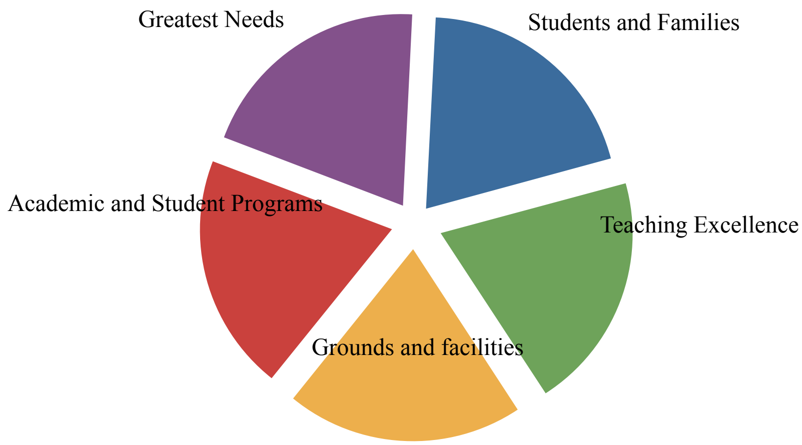
[46] *Annual Report of the President of Stanford University For the Academic Year Ending August 31 1922***.** (Stanford University, CA; Stanford University Press, 1922) Lane Medical Library. Lane Medical Archives., pp. 19-22.

TABLE 6
REPRESENTATIVE ENDOWMENT STRUCTURE



2. Brainstorm to Develop Goals for Each Sector

Once you have determined the appropriate sectors, group all current funds within the appropriate sector. Then, brainstorm about future needs for each sector, thinking generally about the types of resources the organization will need. Determine how much cash flow you will need for each of those ideas, and total them for the sector. Determine the principal you will need by multiply the cash flow by 25 (this will equate to a 4% revenue stream). Add the sectors together, and you have an endowment goal.

C. Best Practice #3: Set Standards for Account Sizes for Management

The single most effective way to eliminate proliferating funds, or funds that will drag your organization off mission, is to set clear policies and work those details out at the outset.

1. Create Giving Options at All Levels

One of the biggest mistakes most charities make is to focus on large endowment gifts. This is often done in order to prevent having small funds with restrictions, which clearly creates problems. Open endowment to all donors by creating a pooled fund in each sector that can receive gifts from $1 to the minimum required for a segregated fund. This allows donors with small gifts to allocate their gift to the sector of greatest interest. The pooled funds allow the donor to select an area of interest without requiring the funds be segregated in a fund for that purpose.

2. Limit Restricted Purposes to Funds of $250,000 or More

Set the minimum for more narrowly restricted funds at a minimum of $250,000 (some charities use figures as high as $1 million). Donors below that level can allocate their gifts to one of the five sectors, but if the donor is to restrict the gift more narrowly than the sector, it must be large enough to justify the costs. Large funds will have the name selected by the donor, will produce annual reports for the fund, and will require the funds be allocated and verified.

3. Recognition Opportunities

Allow donors to name gifts at $50,000. For these gifts between $50,000 and $249,999[47], the donor's name will not be tied to a segregated fund, but to the sector to which the gift is directed. For example, if Kathryn and Ben Miree made a $50,000 contribution to the Teaching Excellence sector, the "Kathryn and Ben Miree Teaching Excellence Fund" would be attached to the sector in the annual report in perpetuity (or for a named period), in addition to other $50,000 - $249,999 gifts committed to that sector. A summary of these recommendations is set out in Table 7.

TABLE 7
GIVING LEVELS AND RECOGNITION STANDARDS FOR ENDOWMENT GIFTS

Level of Giving	*Designation of Use*	*Recognition*
$1 - $49,999	May designate gift to sector to be added to the pool.	Recognized in annual report as a gift to endowment in the year of gift.
$50,000 - $249,999	May designate gift to sector to be added to the pool.	Recognized in annual report as a gift to endowment in the year of gift; name selected by donor (generic to sector) recognized in perpetuity (or for a term) associated with the sector.
$250,000+	May designate the gift sector and a more narrow purpose within the sector; will receive annual statement about use and performance of funds.	Recognized in annual report as a gift to endowment in the year of gift; name selected by donor recognized in perpetuity with the named fund and its purpose.

D. Best Practice #4: Use a Donor-Centric Process to Create New Funds

Use standard, written document with clear definition of gift purpose, flexibility to maximize use of the gift, and the following key terms:

TABLE 8
ENDOWMENT DOCUMENT CHECKLIST

Item	
Fund name	
Amount to be contributed and the timing of those contributions	
Donor goals	
Directives on gift use	
Recognition, if any, to be provided for the gift (and the length of time the recognition is to be offered.	
The document provides enough flexibility to allow the charity to effectively use the funds.	
The purpose is in keeping with the charity's mission.	

[47] If the limit for a segregated fund is $1 million, I would suggest setting the naming opportunity at $100,000 or $200,000.

Item	
The document provides a non-judicial roadmap for change.	
Directives on accounting and reporting (and who is entitled to see the accounting and reporting)	
Provisions for administrative and management fees	
Publicity	
Provisions allowing the investments to be pooled (and disclaimer under the Philanthropy Protection Act of 1995)	
Standing to sue if provisions violated (be careful here not to retain too many rights in the gift to prevent a completed gift)	
Termination	
Other provisions?	

E. Best Practice #5: Adopt and Conduct an Ongoing Review of the Investment Policy Statement Governing Investment Management

1. Laws Governing Investment Management – UMIFA and UPMIFA[48]

In 2006, The National Conference of Commissioners on Uniform State Laws adopted the Uniform Prudent Management of Institutional Funds Act (UPMIFA), applicable to charities organized as nonprofit corporations.[49] This Act updated the Uniform Management of Institutional Funds Act (UMIFA) in place since 1972, and comes close to creating one set of investment standards for all charitable funds whether held in trust or nonprofit corporation form. Table 9 provides the current status of UMIFA and UPMIFA by state. Please be sure to use these as a starting point and check your state's current status. These laws have changed quickly since 2006.

TABLE 9

CURRENT STATUS OF UMIFA AND UPMIFA BY STATE

States that have adopted UMIFA or UPMIFA in whole or in part

State	***Code Section***	***State***	***Code Section***
Alabama (UPMIFA)	§§ 19-3C-1 to 19-3C-10	Montana (UPMIFA)	§§ 72-30-101 to 103; 72-30-207 to 213
Arizona (UPMIFA)	§§ 10-11801 to 10-11805	Nebraska (UPMIFA)	§§ 58-610 to 58-619
Arkansas (UPMIFA)	§§ 28-69-601 to 28-69-611	Nevada (UPMIFA)	§§ 164.640 to 164.680
California (UPMIFA)	Probate Code §§ 18501 to 18510		
Colorado (UPMIFA)	§§ 15-1-1101 to 15-1-1110	New Hampshire (UPMIFA)	§§ 292-B:1 to 292-B:10
Connecticut (UPMIFA)	§§ 45a-435a to 45a-535i	New Jersey	§§ 15:18-15 to 15:18-24
Delaware (UPMIFA)	Tit. 12, §§ 4701 to 4710	New Mexico (UPMIFA)	Art. 9 §§ 46-9-1 to 46-9-12

[48] See the most recent list of state adoption of UMIFA or UPMIFA and statutory references. These state statutes change quickly, so always check your state's current status.

[49] National Conference of Commissioners on Uniform State Laws, *http://www.law.upenn.edu/bll/ulc/umoifa/2006final_act.htm*.

District of Columbia (UPMIFA)	§§ 44-1631 to 44-1639	New York	NPC §§ 102, 512, 514, 522
Florida	Title XLVIII § 1010.10	North Carolina (UPMIFA)	§§ 36B-1 to 36B-10
Georgia (UPMIFA)	§§ 44-15-1 to 44-15-8	North Dakota	§§ 15-67-01 to 15-67-09
Hawaii	§§ 517D-1 to 517D-11	Ohio (UPMIFA)	§§ 1715.51 to 1715.59
Idaho (UPMIFA)	§§ 33-5001 to 33-5010	Oklahoma (UPMIFA)	§§ 60-300.12 to 60-300.20
Illinois	760 ILCS 50/1 to 560 ILCS 50/10	Oregon (UPMIFA)	§§ 128.305 to 128.336
Indiana (UPMIFA)	§§ 30-2-12 to 30-2-12-18	Rhode Island	§§ 18-12-1 to 18-12-9
Iowa (UPMIFA)	§§ 540A.101 to 540A.109	South Carolina (UPMIFA)	§§ 34-6-10 to 34-6-100
Kansas (UPMIFA)	§§ 58-3601 to 58-3610	South Dakota (UPMIFA)	§§ 55-14A-1 to 55-14A-12
Kentucky	§§ 273.510 to 273.590	Tennessee (UPMIFA)	§§ 35-10-201 to 35-10-210
Louisiana	§§ 9:2337.1 to 9:2337.8	Texas (UPMIFA)	Property Code §§ 163.001 to 163.011
Maine	Title 13 §§ 4100 to 4110	Utah (UPMIFA)	§§ 51-8-101–51-8-604
Maryland	Est. & Tr., §§ 15-401 to 15-409	Vermont	Tit. 14, §§ 3401 to 3407
Massachusetts	Chapter 180A, §§ 1 to 11	Virginia (UPMIFA)	§§ 55-268.11 to 55-268.20
Michigan	§§ 451.1201 to 451.1210	Washington	§§ 24.44.010 to 24.44.900
Minnesota (UPMIFA)	§§ 309.62 to 309.71	West Virginia (UPMIFA)	§§ 44-6A-1 to 44-6A-10
Mississippi	§§ 79-11-601 to 79-11-617	Wisconsin	§§ 112.10 to 112.10(7)(b)
Missouri	§§ 402.010 to 402.225	Wyoming (UPMIFA)	§§ 17-7-201 to 17-7-205

States That Have Not Adopted UMIFA or UPMIFA

Alaska, Pennsylvania

The 2006 UPMIFA makes three major changes. First, it updates the prudence standards for investments to more closely mirror the Uniform Prudent Investor Act. Second, it removes the concept of historic dollar value from the spending policy and substitutes a set of standards to govern discretionary decisions about spending. Third, it gives charities more flexibility in long-term management of funds by expanding on the release or modification of donor gift restrictions in Section 6.

- **The Change in Prudence Standards.** UPMIFA provides greater guidance to charities in the factors they should consider in investing funds. The Commissioners list the following in their comments to the draft:[50]
    - Preservation of the endowment fund;
    - Donor intent as expressed in a gift instrument;
    - Good faith actions characterized by the care an ordinarily prudent person would exercise;
    - Reasonable costs in investing and fund management;
    - Reasonable effort to determine and verify relevant facts;
    - Decision making about assets in the context of the portfolio as a whole and that portfolio's investment strategy;
    - Diversification, unless special circumstances make diversification inappropriate;

[50] UPMIFA, Prefatory Note, *http://www.law.upenn.edu/bll/ulc/umoifa/2006final_act.htm*.

- Disposing of unsuitable assets; and
- Using a strategy appropriate for the charity.

- **The Spending Policy.** UMIFA allows a spending policy that distributes both accounting income and appreciation so long as the fund does not drop below its "historic dollar value." However, the Commissioners felt this policy created several problems for charities:
  - ✓ The historic dollar value was fixed at an arbitrary point in time, often based on the donor's death. If it was fixed as the market moved up, the charity had some flexibility; if it was fixed as the market moved down, the charity would be limited in its ability to use the funds.
  - ✓ After a period of time—especially when the endowment has far outstripped its historic dollar value—the mark becomes less relevant. Indeed, charities may be tempted to spend well over judicious amounts believing they should spend the balance down to its historic dollar value.
  - ✓ Charities with individual funds—and entire endowment funds—that are "underwater" (below the historic dollar value) have struggled to remedy the situation while following the donor's directions. UMIFA provides little guidance on what to do in these situations.

Therefore, UPMIFA changed the spending policy in Section 4 by removing the reference to historic dollar value and substituting the following standards to guide the charities judgment in making distribution decisions:

- The duration and preservation of the endowment fund;
- The purposes of the institution 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 institution; and
- The investment policy of the institution.

- **Changing and Releasing the Use or Purpose of the Fund.** Specifically, the 2006 model UPMIFA allows changes to the use or purpose of a fund under 4 circumstances:
  - ✓ *Donor Release*: "With the donor's consent in a record," the charity can release a restriction in whole or in part, so long as the gift is still used for the organization's charitable purposes.[51]
  - ✓ *Doctrine of Deviation*: If a modification to a gift agreement/document will enhance the furtherance of the donor's purposes, or a restriction is "impracticable or wasteful and impairs the management or investment of the fund," the charity can ask a court to modify the restriction. The Attorney General must be notified and allowed to be heard, and the modification must reflect the donor's "probable intention." [52]
  - ✓ *Doctrine of Cy Pres*: If the purpose or restriction becomes "unlawful, impracticable, impossible to achieve, or wasteful," the court may use the cy pres doctrine to modify the fund purposes. The Attorney General must be notified and allowed to be heard.
  - ✓ *Small Funds*: For funds with a value less than $25,000 that have been in place more than 20 years, court action is not required if the charity determines a restriction is "unlawful, impracticable, impossible to achieve, or wasteful" so long as the charity waits 60 days after notice to the state Attorney General of the intention to make the change, and the change is designed to be a good

[51] UMIFA 2005, Section 6(b).

[52] UMIFA 2005, Section 6(c).

faith reflection of the expressed charitable purposes.[53] Some states have raised the $25,000 small fund amount to as much as $100,000 in enacting the uniform statute.

2. Other Considerations

a) Adopt written investment policies that guide asset allocation, restrictions on risky assets, and clear objectives and statements of risk.
b) Use a qualified professional investment manager to manage the funds.
c) Monitor the professional manager (using the policies as your standard) on a regular basis; do not be afraid to ask questions and understand the management philosophy.
d) Do not invest in any asset you do not understand. If you do not understand how the asset is structure or how it performs, you will be unable to monitor its performance.

F. Best Practice #6: Develop a Spending Policy to Govern Distributions of True Endowment and Quasi-Endowment (And Stick to It)

1. Spending Policy for Endowed Funds

Spending policies are normally set as a percentage of a rolling 12-quarter average or a variation on that theme. The “look back” and average assures the spending policy remains relatively stable, but in difficult times, spending policies may decrease so as not to put too great a burden on the principal. In good times, most spending policies hover in the 5% to 6% range; in difficult economies those spending policies fall to the 4% to 4.5% range. The spending policy for true endowment should comply with the state’s UMIFA or UPMIFA standards.

2. Principle Distributions from Quasi-Endowment

It is easy to simply reach into quasi-endowment and spend it down during tough economic times. Adopt policies that make it possible - but difficult to do so. Establish clear parameters in policies - before the economic crisis arises - that clearly establish the circumstances under which quasi-endowment can be spent as operational funds and who must approve that use. Do not keep operating reserves in endowment. Operating reserve funds are generally invested in a more long-term position that operating funds (which, if invested, are in overnight cash) but they are not suited for funds invested with a 8-10 year horizon.

G. Best Practice #7: Set – And Execute – Standards for Stewardship

Organizations with successful endowment have strong stewardship programs vested in the development department. Endowment donors are some of your best investors and should be treated that way. Adopt stewardship policies that specify:

- Basic stewardship standards for each level of endowment;
- What you you should communicate - that is, how you will report the impact and value of the fund;
- When to communicate - that is, how often you will communicate about the fund’s impact and value (generally annually);
- To whom you communicate - that is, with the donor, with the donor’s family, and the length of time you will communicate.

[53] UPMIFA 2006, Section 6(e).

H. Best Practice #8: Keep the Endowment – And Endowment Impact – Visible Year Round

Communication should not only focus on the donor and the donor's family, it should focus on endowment prospects and the general public as well.

- *Board reports.* Keep the board informed throughout the year. Provide a report on the endowment, the number of current funds, the number of new funds, the investment performance, the first managing the funds, and the impact of endowment on the organization's mission.
- *Annual report.* Report on the endowment, the number of funds, those with permanent funds, investment performance, the impact of the fund, and the annual impact. Be sure to include information on how donors can create a personal impact.
- *Website.* Include information on endowment on the website. This should include the information in the annual report as well as instructions on how to name the endowment under a will, trust, or as beneficiary of a life insurance or retirement/IRA plan, how to get a sample fund document, and who to contact to have a deeper conversation.
- *Development materials.* Create an annual endowment report that can be used to talk with donors about endowment. Include information in basic giving brochures and planned giving brochures. Position the endowment and its purpose and encourage donors to give at all levels.
- *Newsletters, magazines, and other platforms.* Everyone who receives a newsletter, magazine or other communication from your nonprofit is a prospect. Include stories of donors who have created funds (living and deceased) at all gift levels and the impact of their gift. Refer readers to the website for more information.

I. Best Practice #9: Remain in Constant Communication with Donors

Most problems between nonprofits and donors (or donors' family members) could have been alleviated, mediated, or reduced in scale through discussions and an effort to resolve the issue at the front end. Once a donor or donor's family has been stonewalled, ignored, or cut off, it is no longer possible for a possible settlement. Be clear at the creation of the fund to establish open communication. Document the files to clearly communicate to the next staff member any conversations or expectations of the donor the nonprofit agreed to. (These should all be reduced to writing in the document at the beginning, but sometimes resolution of small issues occurs along the way.) Provide transparent, annual communications. Engage the donor's family after the death of the donor.

III. Solving Endowment Problems

A. Typical Problems

Sometimes documents have provisions that create significant administrative problems and a change must take place to reduce costs or increase the effectiveness of the funds. Consider the most common problems and solution options.

1. Investment Restrictions

Sometimes - especially in older documents with conservative donors - investments are restricted to specific assets, the document requires a formula distribution such as "80 percent of the earnings shall be distributed and 20% of the earnings shall be reinvested to provide growth for the underlying funds." Any type of investment restriction limits the charity's ability to pool the funds for long-term investment purposes and automatically requires that the fund be segregated and invested separately.

2. Distribution Restrictions

In other cases, there are distribution restrictions. The restriction usually relates to how the funds are used, but may also direct a specific annual distribution (such as 5%). Restrictions may state the funds are to be used solely for a specific program which no longer exists or is fully funded or the funds may be restricted for a broader purpose which is no longer a nonprofit priority.

3. Small Funds

One of the most vexing problems may be small funds. The definition of "small funds" may vary from institution to institution, but are generally funds of $100,000 or less. (Some may define as $25,000 or less.) These funds may not be a problem in the early years of endowment when every dollar is welcome, and segregated funds are offered at low levels. It does become a problem as the number of funds increases to several hundred and then several thousand requiring more and more time to account and report.

B. Options in Solving Problems

Once charities begin to struggle with endowment restrictions and the number of funds, options may be limited. Here are the current alternatives. Review your documents now so that if there are problems that may create difficulty down the road, you have the greatest number of options.

1. Document Solutions

An obvious solution would be to include a provision for dissolution of small funds in the governing document. The provision can direct that when the fund gets to a certain dollar value the charity can expend the balance for the fund's purpose, can pool the funds with the charity's unrestricted endowment, or can combine the fund with any of the charity's larger segregated funds that comes as close as possible to the fund's purpose.

2. Living Donors

UMIFA and UPMIFA allow living donors to make modifications. This is the second simplest, non-judicial way to make a change to the document.

3. Statutory Solutions

If the donor is not living, and the fund has existed for a long enough period to qualify for one of the other solutions under UPMIFA, the charity may find this a viable option. Read your state statute to determine under which circumstances changes can be made. The state attorney general must receive notice and have time to respond to the proposed changed, but it may offer a solution.

4. Judicial Solutions

The final option - and the only one available for many funds - is to take the documents to a court of equity and ask the court to intervene to solve the problems. This is the only solution for some problems, such as larger funds with investment restrictions. Some charities, after review of all endowment documents, have taken in groups of documents in a single hearing, all with the same issue. Other funds - especially if they are large - are taken in singly to seek resolution. The state's Attorney General is a party to these proceeding representing the public's charitable interest.

IV. Final Thoughts

Effective, growing, endowments are not created by accident - but by design. A successful endowment involves a team comprised of the finance office, the investment manager, and the development/stewardship office. Start now to address issues in existing endowments, and to prevent future problems with strong endowment policies. A donor-centric focus will building increasingly strong resources long-term.

For more information:

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