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ENDOWMENT LAW

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1. What is an endowment?

   A. In Common Usage. The term \textit{endowment} is widely used to mean donated funds that are set aside and invested to provide a long-term source of income for the charity. “Most endowments are designed to keep the principal corpus intact so it can grow over time, but allow the nonprofit to use the annual investment income for programs, or operations, or purposes specified by the donor(s) to the endowment.”\(^1\)

   B. In New Accounting Rules. The Financial Accounting Standards Board (FASB) issued new guidance in 2016\(^2\) that defines \textit{endowment fund} to mean:

   An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit entity (NFP). The use of the assets of the fund may be with or without donor-imposed restrictions. Endowment funds generally are established by donor restricted gifts and bequests to provide a source of income in perpetuity or for a specified period. See \textit{Donor-Restricted Endowment Fund}. Alternatively, an NFP’s governing board may earmark a portion of its net assets as a Board-Designated Endowment Fund. See \textit{Funds Functioning as Endowment}.

   The FASB guidance says that \textit{quasi-endowment fund}, \textit{board-designed endowment fund}, or \textit{fund functioning as endowment} all mean the same thing: Assets designated by the nonprofit’s governing board to be held and invested as an endowment fund, when the donor(s) of those funds did not restrict them to endowment use.

   C. Legal Definition. The Uniform Prudent Management of Institutional Funds Act, Cal. Probate Code §18501 \textit{et seq.}, defines \textit{endowment} as follows:

   “Endowment fund” means an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment fund for its own use.\(^3\)

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\(^3\)
II.  **The Law of Endowments**

A.  **Charitable Trust.** Under common law, gifts to charitable organizations are treated as a type of charitable trust, and the restrictions imposed by donors are enforceable under trust law.\(^4\) This is true even if the gift is made to a nonprofit corporation or association, rather than trust-form charity. Using the gifts for another purpose, even a worthy or charitable one, is a breach of trust.\(^5\) In California, this common-law doctrine is reflected in Bus. & Prof. Code §17510.8, which states:

“The acceptance of charitable contributions by a charity … establishes a charitable trust and a duty on the part of the charity … to use those charitable contributions for the declared charitable purposes for which they are sought. This section is declarative of existing trust law principles.”

B.  **UPMIFA.** The Uniform Prudent Management of Institutional Funds Act, or UPMIFA, was enacted to clarify the legal standards that apply to endowments. Versions of the model act have been enacted in 49 states (all but Pennsylvania) and in the District of Columbia. In California, UPMIFA was enacted as §§18501-10 of the Cal. Probate Code. As discussed in more detail below, UPMIFA addresses three key aspects of endowment management:

- How should the funds be invested?
- How much can the charity spend each year?
- How can donor restrictions on the use or management of the fund be changed?

C.  **Contract Law.** Under traditional contract law principles, a charitable pledge or gift agreement is enforceable when the charity provides return consideration to the donor, or when the charity or other donors rely to their detriment on the pledge.\(^6\) A charity’s promise to use funds for a particular purpose, or manage them in a particular way, may also be enforceable against the charity as contractual obligation when the gift was made pursuant to an enforceable agreement.

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\(^{3}\) Cal. Probate Code §18502(b).


\(^{5}\) See, e.g., *College of Osteopathic Physicians and Surgeons*, 61 Cal.2d 750 (1964).

III. When Does UPMIFA Apply?

A. UPMIFA Applies to Institutional Funds. Institution is defined in Cal. Probate Code §18502(d) to mean “any of the following:

(1) A person, other than an individual, organized and operated exclusively for charitable purposes.
(2) A government or governmental subdivision, agency, or instrumentality, to the extent that it holds funds exclusively for a charitable purpose.
(3) A trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated.”

Institutional fund is defined in Cal. Probate Code §18502(e) to mean “a fund held by an institution exclusively for charitable purposes,” but the term does not include any of the following:

“(1) Program-related assets.
(2) A fund held for an institution by a trustee that is not an institution.
(3) A fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund.”

Under these broad definitions, UPMIFA applies to any charitable nonprofit corporation or association, and covers both endowed and non-endowed funds.

B. Funds held by trust-form charities are excluded. UPMIFA generally does not apply to funds held by trust-form charities,\(^7\) because of the exclusion of any fund “held for an institution by a trustee that is not an institution.” Cal. Probate Code §18502(e)(2). A trust-form charity is an institution,\(^8\) but it’s individual or corporate fiduciaries usually are not, so UPMIFA doesn’t apply to its funds. Instead, ordinary trust law governs investment, spending, and modification of the funds.

C. UPMIFA spending rules only apply to donor-designated endowments. UPMIFA defines endowment fund to mean fund that cannot be currently spent under the terms if its gift instrument. Cal. Probate Code §18502(b). Gift instrument is broadly defined to mean “a record or records, including an institutional solicitation, under which property is granted to, transferred to, or held by an institution as an institutional fund.” Cal. Probate Code §18502(c). While UPMIFA applies to all endowment funds, its rules about how much a charity can spend each year only affect donor-designated endowments.

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\(^7\) Uniform Prudent Management of Institutional Funds Act, NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, Nov. 8, 2007, p. 10 (comment on definition of “institution”).

\(^8\) See Cal. Probate Code §§18502(f) (defining “person” to include a trust) and 18502(d)(1) (defining “institution” to include any person organized and operated exclusively for charitable purposes). [00015522-3]
IV. Investment of Endowment Funds

A. Duty of Care. Cal. Probate Code §18503 addresses the investment of endowments and other institutional funds. It imposes a general duty of care: “In addition to complying with the duty of loyalty imposed by law other than this part, each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.”

B. Delegation. Standards for delegating the investment and management of institutional funds are provided in Cal. Probate Code §18505. Section 18505(e) provides that a charity may delegate investment management internally “to its committees, officers, or employees as authorized by law of this state….”

A charity may also delegate investment management to external investment managers. Section 18505(a) requires that the charity act “in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, in all of the following:

(1) Selecting an agent.

(2) Establishing the scope and terms of the delegation, consistent with the purposes of the institution and the institutional fund.

(3) Periodically reviewing the agent’s actions in order to monitor the agent’s performance and compliance with the scope and terms of the delegation.”

C. Factors to consider. Section 18504 mandates that a charity consider “consider the charitable purposes of the institution and the purposes of the institutional fund” in making management and investment decisions. Subject to donor intent expressed in the gift instrument, the charity must also consider:

(A) General economic conditions.

(B) The possible effect of inflation or deflation.

(C) The expected tax consequences, if any, of investment decisions or strategies.

(D) The role that each investment or course of action plays within the overall investment portfolio of the fund.

(E) The expected total return from income and the appreciation of investments.

(F) Other resources of the institution.

(G) The needs of the institution and the fund to make distributions and to preserve capital.

(H) An asset’s special relationship or special value, if any, to the charitable purposes of the institution.
UPMIFA provides that “[m]anagement and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund’s portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution.”

Although investment standards in Cal. Corp. Section 5240 (applicable to California nonprofit public benefit corporations) are different, Section 5240(e) now states that if the Board complies with UPMIFA, it will be deemed to be in compliance with Cal. Corp. Section 5240.

D. **Duty to diversify.** Unless the donor’s gift instrument provides otherwise, charities have an affirmative duty to “diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification.” Cal. Probate Code §18503(e)(4). UPMIFA mandates that “[w]ithin a reasonable time after receiving property, an institution shall make and carry out decisions concerning the retention or disposition of the property or to rebalance a portfolio …” to comply with UPMIFA investment standards. Cal. Probate Code §18503(e)(5).

V. **How much can a charity spend each year?**

In the case of donor-designated endowments (i.e., funds donated to the charity subject to an endowment restriction), the amount that a charity can spend each year is governed by Cal. Probate Code §18504. (If the endowment is board-designated, then the charity can spend any amount its Board decides is appropriate—a board-designated endowment isn’t an “endowment” under the UPMIFA definition.)

A. **General rule: Whatever is prudent.** Section 18504(a) provides, “Subject to the intent of a donor expressed in the gift instrument, an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. … In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, all of the following factors:

1. The duration and preservation of the endowment fund.
2. The purposes of the institution and the endowment fund.
3. General economic conditions.
4. The possible effect of inflation or deflation.
5. The expected total return from income and the appreciation of investments.
6. Other resources of the institution.
7. The investment policy of the institution.”
A donor can override this standard, and impose a different spending rule, but only if the donor’s limitation on the charity’s authority is specifically stated in the gift instrument. Cal. Probate Code §18504(b).

B. Most endowment gift instruments do not change the “prudent” rule. Under Section 18504(c), “Terms in a gift instrument designating a gift as an endowment, or a direction or authorization in the gift instrument to use only “income,” “interest,” “dividends,” or “rents, issues, or profits,” or “to preserve the principal intact,” or words of similar import have both of the following effects:

(1) To create an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund.

(2) To not otherwise limit the authority to appropriate for expenditure or accumulate under subdivision (a).”

C. Rebuttable Presumption of Imprudence. Section 18504(d) creates a rebuttable presumption that a charity has acted imprudently if it spends, in one year, more than 7% of the fair market value of the endowment fund. The 7% amount is calculated based on average quarterly values over three past years. This “rebuttable presumption of imprudence” doesn’t apply to colleges and universities, or to their campus foundations.

VI. Modifying Gift Restrictions

Modification of donor restrictions on institutional funds is covered in Cal. Probate Code §18506, which provides three ways that an institutional fund can be modified:

- If the donor consents in a record, the charity can modify the fund purpose. §18506(a).

- If the donor’s purpose restrictions are unlawful, impracticable, impossible to achieve, or wasteful, a court can modify the purpose of the fund. A court can also modify a donors’ mandates regarding the management or investment of the fund if they impracticable or wasteful, or impair the management or investment of the fund, or because of a change in circumstances. §18506(b) and (c).

- For funds that are over 20 years old, and have a total value of less than $100,000, the charity can modify restrictions that are unlawful, impracticable, impossible to achieve, or wasteful, upon 60 days’ notice to the Attorney General and the donor. §18506(d).

Modification of restricted funds is discussed in the attached article, Changing the Purpose on Past Charitable Gifts [sic], PLANNED GIVING TODAY, April 2017.
VII. Endowments in Practice

A. Starting an endowment

A charity’s board can create a board-designated endowment by setting aside funds that will be invested for the long-term production of revenue. To launch a donor-designated endowment, the charity can ask donors for endowment gifts.

Gift Acceptance Issues. If each donor drafts his or her own gift restrictions, a charity can wind up with the administrative headache of many small, named funds with disparate gift restrictions.

- Charities can proactively write their own endowed fund descriptions and encourage donors to give to those pre-defined, broadly-restricted funds.
- Gift acceptance policies should address acceptance of endowment gifts made subject to restrictions that would require creation of a separate fund.
  - Size minimums are common
  - Should be some management review of purpose restrictions

B. Managing endowments

Investment policy and investment performance. Any charity with an endowment fund or substantial reserves should have an investment policy, and its Board or a committee should regularly review investment performance. Small charities that find this burdensome might consider partnering with a community foundation that offers agency funds or nonprofit investment funds.

Spending policy. Charity boards must adopt a spending policy or policies to decide on the payout for each fund (i.e., how much of each endowment fund it will spend on program and operations each year). While UPMIFA provides a long list of factors for institutions to consider, most charities aim to set a spending rate that preserves the real value of the principal. Spending policies are often based on a percentage of endowment fund value, calculated as a rolling average over 3-5 years.

Charity boards are not required to apply the same percentage to each endowment fund (and in fact are required to consider the particular purpose of each fund when determining the payout amount).

Record retention. Any charity that has endowment funds should plan to keep documentation of the gift terms and purpose in its permanent records.
Changing the Purpose on Past Charitable Gifts

BY BARBARA RHOMBERG

Donor-restricted gifts can be a mixed blessing. Sometimes charities hold donated funds that are difficult to use for their originally designated purpose. This arises most often with endowment funds that were established years or decades ago.

Purpose restrictions in current-use funds can also be problematic, if unanticipated circumstances develop after the gifts were made. At other times, it is the donors (or their family members) who change their minds and ask to redirect previous contributions.

In either case, a charity may be interested in changing the purpose of previously made gifts, so that money can be released for a different use. Any organization contemplating such a move must consider:

- Donor relations with those who gave the restricted funds
- Public relations with other donors, volunteers, and the at-large community
- Accounting standards for reporting restricted fund transactions
- Legal rules governing the use of donor-restricted gifts

All of these considerations are important, but this article focuses on the legal aspects of changing the purpose of restricted funds.

Enforceability of Restrictions

A charity's legal obligation to use a gift for the purpose specified by the donor

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stems primarily out of charitable trust law. Gifts and bequests to charitable organizations are deemed to create a charitable trust, and the purpose restrictions imposed by donors are enforceable under trust law. This is true even if the gift is made to a nonprofit corporation or association, rather than trust-form charity. Using the contributions for another purpose, even a worthy or charitable one, is a breach of trust.

Charitable trust restrictions are usually established by the donor through bequest terms, a gift agreement, or written instructions. If a charity asks donors to contribute for a specific purpose, the resulting gifts are restricted and held in trust for that use under UPMIFA §2(3).

Contract law is also a factor when funds were received in connection with a gift or grant agreement, though applicable law varies from state to state. Pledge agreements that seek to make future charitable gifts are sometimes enforceable. Under traditional contract law principles, a charitable pledge is enforceable when the charity provides return consideration to the donor, or when the charity or other donors rely to their detriment on the pledge. While a court recently ruled that a foundation has a contract claim against a donor, others denied enforcing a pledge because consideration and detrimental reliance were lacking.

Although most court cases about the enforceability of gift agreements arise when charities try to enforce a pledge against a donor or donor’s estate, a charity’s promise to use funds for a particular purpose may be enforceable against the charity as contractual obligation when the gift was made pursuant to an enforceable agreement.

Under the traditional trust law doctrine of cy pres, a court may modify the terms of a charitable trust when its stated purpose has become impossible, impracticable, illegal, or wasteful. The modified use must fulfill the donor’s charitable intent as closely as possible.

Cy pres is used to modify stand-alone charitable trusts, but this doctrine also has been applied to restricted gifts and endowments held by nonprofit corporations and associations. It may still be used to modify charitable gifts when the Uniform Prudent Management of Institutional Funds Act (UPMIFA) does not apply. For example, if real estate was donated for use in a nonprofit’s program, UPMIFA does not apply. A cy pres action would therefore be required to modify the donor’s restrictions on use of the property.

UPMIFA is often thought of as a law that regulates endowment spending. However, it applies more broadly to all institutional funds (not just endowments) and it both codifies and expands the cy pres doctrine relating to the modification of donor restrictions. It is a uniform law, meaning a committee of experts wrote a model statute and encouraged state legislatures to adopt it. UPMIFA has been enacted in 49 states (all but Pennsylvania) and in the District of Columbia. Some state legislatures tinkered with the model law when they enacted it, so provisions vary somewhat from state to state.

UPMIFA applies to all institutional funds, and “institution” is defined in §2(4) to mean any entity that is organized and operated exclusively for charitable purposes. The term also includes a government agency or instrumentality to the extent that it holds funds exclusively for charitable purposes. A split-interest trust after all noncharitable interests have terminated is an institution under UPMIFA.

Institutional fund is defined in UPMIFA §2(5) as “a fund held by an institution exclusively for charitable purposes.” This includes both endowed and nonendowed funds. The definition of “institutional fund” excludes (1) program-related assets held to accomplish an exempt purpose and not for investment, (2) funds held by outside noncharitable trustees, and (3) any fund in which a beneficiary that is not an institution has an interest. Under these broad definitions, UPMIFA applies to any charitable or educational nonprofit organization (including state universities) and covers both endowed and nonendowed funds.

For institutional funds, it enables a charity to modify restrictions contained in the gift instrument. Section 2(3) of UPMIFA defines gift instrument as “a record or records, including an institutional solicitation, under which property is granted to, transferred to, or held by an institution as an institutional fund.” This includes will and trust language, gift and pledge agreements, and transmittal letters from the donor. It also

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encompasses proposals or solicitation language from the charity.

UPMIFA provides three ways that a charity can modify restrictions on institutional funds: by donor consent, by court order, or for small old funds with notice to the state’s attorney general.

Donor Consent

Purpose restrictions can be changed with the written consent of the donor in §6(a) of UPMIFA.

If the donor consents in a record, an institution may release or modify, in whole or in part, a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund. A release or modification may not allow a fund to be used for a purpose other than a charitable purpose of the institution.

The donor’s consent must be in a record. UPMIFA §2(8) defines a record as “information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.” A letter or agreement signed by the donor meets this standard, but the donor’s consent need not be so formal — an email from the donor will also suffice. However, a donor’s verbal permission to modify the terms of the gift would not satisfy the statute, since the consent would not then be in a record.

While donor consent is required, the charity holding the fund must also take some action. UPMIFA states that the institution (not the donor) releases the restriction. The charity’s action to modify the restriction, by the board of directors or by staff if such authority is delegated, should be documented in the charity’s records.

If the donor consents in writing to change a fund’s purpose, there is no requirement that the new purpose be related in any way to the original gift designation — the donor and charity can agree to do something completely different, as long as the new use is a charitable one. Further, no justification or grounds for modification is required. The change can be made simply because the donor and charity have changed their minds.

Court Order

A charity may also get a court order that permits a modification of fund terms. UPMIFA §6(c) provides, “If a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund becomes unlawful, impracticable, impossible to achieve, or wasteful, the court … may modify the purpose of the fund or the restriction on the use of the fund in a manner consistent with the charitable purposes expressed in the gift instrument.”

The original fund purpose must be unlawful, impracticable, impossible to achieve, or wasteful for a charity to alter a fund purpose using this second mechanism. The court may only act if the charity can show that one of these specific grounds for modification exists. A restriction is impracticable if adhering to the restriction is unreasonably difficult or would not accomplish the donor’s overall charitable objective. It is not enough to show that the funds could be better spent by changing the donor’s designated purpose.

The new fund purpose must be consistent with the charitable purposes expressed in the gift instrument. This UPMIFA provision is a codification of cy pres, which mandates a use as close as possible to the donor’s original designation. The wording of UPMIFA is different, but the court will still look for a use that conforms as much as practicable to expressed donor intent. See CHANGING: Page 10
The original restrictions must be unlawful, impracticable, impossible to achieve, or wasteful.

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Equitable deviation is a trust law procedure that allows the administrative terms of a trust to be modified. UPMIFA also codifies this doctrine, and provides that a court can order relief from a fund's cumbersome administrative requirements or unfortunate investment restrictions. Section 6(h) provides that a court can modify restrictions in a gift instrument “regarding the management or investment of an institutional fund if the restriction has become impracticable or wasteful, if it impairs the management or investment of the fund, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund . . . To the extent practicable, any modification must be made in accordance with the donor’s probable intention.”

UPMIFA requires that the state’s attorney general be notified of any petition asking a court to modify the charitable purpose or administrative terms of a fund.

Small Old Funds

The third method of modifying purpose restrictions applies only to small old funds (how old and how small the fund must be depends on the version of UPMIFA adopted in the charity’s state). For qualifying small old funds, UPMIFA §6(d) allows the charity to modify the terms unilaterally following notice to the state’s attorney general.

If an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution, [60 days] after notification to the [attorney general], may release or modify the restriction, in whole or part, if: (1) the institutional fund subject to the restriction has a total value of less than [25,000]; (2) more than [20] years have elapsed since the fund was established; and (3) the institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument.

The model UPMIFA statute requires that a fund be older than 20 years, and with a total value of less than 25,000, for this third method of fund modification to apply. Some states, for example Oregon and Texas, enacted these criteria without change. A number of states increased the dollar limit on the size of the fund; in New York and California, for example, funds up to $100,000 may be modified under this provision. Ohio raised the limit to $250,000, and applies it to funds that are at least 10 years old.

The model law did not require any notice to the donor prior to the modification of small old funds. The drafters reasoned that “an institution’s concern for donor relations would serve as a sufficient incentive for notifying donors when donors can be located.”

Some states, such as California and New York, added a legal requirement that charities notify donors when they propose to modify small old funds under this provision. California requires notice to donors at their last known address in the nonprofit’s records. New York requires notice to individual donors if they are alive, and to institutional donors if they still exist and carry on activities, if the donors can be identified and located with reasonable efforts.

Under this method, the original fund restrictions must be unlawful, impracticable, impossible to achieve, or wasteful, and the revised fund purpose must be consistent with the charitable purposes expressed in the gift instrument. These substantive requirements are the same as if the charity had sought a court order to modify the fund. The UPMIFA provision for modifying small old funds provides a simplified process to avoid the (often prohibitive) cost of going to court.

The language of the model act allows restrictions on the “management, investment, or purpose of an institutional fund” to be modified if the requisite cause can be shown. This seems to include an endowment restriction, which would likely be characterized as either a purpose or a management restriction. It follows that a fund could be unendowed if the charity can show that continuing to hold the fund as an endowment is impracticable, and that current use (rather than combining it with a larger endowment fund) is most consistent with donor intent.

Changing the purpose of previously received gifts takes time and resources, but the rewards can be enormous for a charity that has disused and unusable funds that can be put back to work.