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## Endowments in the Time of Coronavirus

Nonprofits across the country have been hit with a massive double blow. COVID-19 has shut down charitable activities and frozen many revenue streams, forcing many nonprofit employers to streamline operations, and potentially to lay off staff. At the same time, stock market losses in recent weeks have put great strains on endowments. Many nonprofits find themselves looking to remaining endowment funds to help supplement operating funds until things stabilize, but are appropriately nervous about violating state law by misusing endowments. To what extent can nonprofits activate their remaining endowments to keep themselves afloat?

### **An Endowment By Any Other Name**

The first step is to confirm whether the fund is really a restricted endowment fund. Many use that term loosely to mean funds that the nonprofit intends to grow, in the hopes of living off of the income. However, an endowment fund may be purely a “board-designated” endowment, with no donor restrictions on use of the funds. “Board-designated” endowments generally can be used for any purpose, if the board decides that it is appropriate and in the nonprofit’s best interests to repurpose those funds. On the other hand, where spending restrictions are imposed by donors, boards do not have unilateral authority to remove those restrictions.

Be careful not to rely solely on internal communications, or on how funds have been reported in audited financials, in determining whether a fund is board-restricted or donor-restricted. The key lies in donor communications. If the funds came from a small handful of individuals, the correspondence related to the gift may make clear whether the donor intended the funds to be subject to restrictions.

Where funds are raised as part of a capital campaign and the donor has not placed express restrictions on a gift, the question then is whether a reasonable person in the donor’s shoes would expect that gift to be subject to restrictions. Campaign materials promising that a certain portion of funds will be held in an endowment restricted to income may create donor restrictions by implication. However, materials that clearly frame building of an endowment as a potential goal of the raise, but not as a commitment, may well not create donor restrictions.

### **How Much of the Endowment Can We Use?**

If you reasonably determine that your fund is not a restricted endowment fund, you can use as much as the board determines to be in the nonprofit’s best interests. Of course, be sure to comply with any purpose restrictions that may apply to the funds. If you are uncertain, consult



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with an attorney. Having a legal opinion from an attorney can help demonstrate that the board has acted in a manner consistent with its fiduciary duties in making the decision to transfer these funds from the endowment to general operating funds.

Assuming that your fund is truly a donor-restricted endowment fund, then (unless the fund instrument sets more strict limitations) you are generally allowed under Massachusetts law to appropriate a "prudent" amount each year, based on various facts and circumstances (described in "UPMIFA", the Uniform Prudent Management of Institutional Funds Act, found in Chapter 180A of the Massachusetts General Laws). Many nonprofits set a percentage spend rate, with the percentage applied to an amount equal to the average value of the endowment over the previous three years (or something similar). This formulation allows the nonprofit to establish a relatively predictable flow of distributions that is less impacted by market volatility.

It is possible to appropriate more than this amount in a given year, if you can establish that a higher amount is "prudent" under the circumstances. Given that one of the factors that you must consider is the intended duration and preservation of the fund (as well as the intended purposes of the fund), you should exercise caution before varying from established spend rates, especially in down markets where a higher draw will significantly reduce corpus and make it harder for the fund to share in any stock market recovery. Increased spend rates or special appropriations may well be "prudent" in particular cases, but the board should devote considerable effort to determining and documenting the reasonableness of any such decision, balancing immediate circumstances with the long-term purposes and viability of the fund.

### **Can We Remove Restrictions And Use More?**

The only parties who can remove donor restrictions on funds are (1) the donors and (2) the court. Where the donors are alive and identifiable, you may ask their permission to remove restrictions, including spending restrictions. However, where funds are raised as part of a campaign, it is likely that those funds derived from a host of different sources, including anonymous donations, and donations from donors who have since passed away. In that case, your only remedy may be a court action.

In order to get court relief, you will need to convince the court (in consultation with the Attorney General's Charities Division, which is a necessary party to such an action, at least for Massachusetts charities) that maintenance of the restrictions is impossible, impracticable or wasteful. You will also need to propose an alternative that hews as closely as is practicable to the original restrictions. Where seeking to remove endowment restrictions, you will need to demonstrate why your non-restricted funds and sources of revenue are insufficient, and that



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you have taken reasonable steps to explore alternatives (such as borrowing money or soliciting additional contributions). Your case will be stronger if you can promise to the court that you will minimize the deviation as much as possible. For example, you may seek release only to the extent necessary to address the immediate emergency, or indicate that you will increase the permitted spend rate but not release spending restrictions entirely.

### **Can We Borrow From the Endowment?**

Some have promoted borrowing as a viable means of tapping into an endowment's value to tide the nonprofit over in difficult times. You should be extremely cautious about taking this approach, however. The theory for allowing this sort of borrowing sounds in the nonprofit's investment authority - a nonprofit is allowed to invest its assets in various vehicles, which may include investing in promissory notes (by lending money to others for interest). In theory, the endowment could convert part of its liquid assets into an interest-bearing note owed to the nonprofit's general operating funds. If done correctly, this is arguably not an appropriation of funds, but rather just an investment by the endowment.

However, a board is required to invest funds prudently, and what prudent investor would convert liquid funds into a debt owed by a (presumably) insolvent debtor, with no security? Generally, the interest rates are low (as the nonprofit is negotiating with itself regarding how much it will need to repay the endowment), and in practice that interest is generally not actually paid or credited, but rather accrues (because the nonprofit often doesn't have the funds to pay it, or it wouldn't be doing this in the first place). Quite frequently, this sort of borrowing is the beginning of a financial death spiral, and as the nonprofit's shortfalls continue, and as the debt grows and repayment becomes increasingly unlikely, the arrangement becomes a de facto appropriation of funds. A director who allows this to continue, knowing the debt will likely never be repaid, is potentially at risk of breaching his or her fiduciary duties. Accordingly, while there may be limited situations where borrowing against endowment may be appropriate, it should be considered only as a last resort and in consultation with legal counsel and with the Massachusetts Attorney General's office.

### **We Need Money Now - So What Do We Do?**

If you find yourself facing a choice between appropriating more from endowment funds or having to terminate all operations, here are some steps to consider:

- Review the original gift documents, to the extent available, to see if there is a reasonable argument that donors have not restricted you from appropriating more from the fund.
- Speak with donors and see if they will agree to eliminate spending restrictions with



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respect to their gifts. If you get permission, you will need to determine the portion of the endowment that is attributable to a particular donor's gift in order to determine how much you can spend.

- Consider the fund's historic spend rate and whether an adjustment would be prudent under the circumstances.
- Consider streamlining operations as much as practicable.
- If you decide that you need to explore borrowing against a fund, document very carefully why you feel that you have no choice (having explored all practical alternatives), why you believe that the debt, considered together with the fund's other investments, may constitute a prudent investment, and how you plan to repay the debt within a reasonable period of time. Consult in advance with the Massachusetts Attorney General's Charities Division, which may require you to get permission from the court.
- Whatever you do, emphasize process - active board involvement, robust consideration of viable alternatives, consultation with professional advisors, and clear documentation - so that you can demonstrate that you are taking your fiduciary duties seriously and acting reasonably and in the best interests of the charity.

These are difficult times, and no one wants to see a nonprofit have to close its doors. Tread carefully with respect to endowment funds, and do your best under the circumstances to balance respect for donor restrictions with the best interests of your charity and the community it serves.

### Contact Us

For further information, please contact your Hemenway & Barnes advisor or the author of this alert: Brad Bedingfield, Chair of the Nonprofit Group, 617-557-9704, [bbedingfield@hembar.com](mailto:bbedingfield@hembar.com)

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